No. 95-323-CFX
Status: GRANTED

Title: United States, Petitioner
v.
Thomas R. Noland, Trustee for Debtor First Truck Lines, Inc.

Docketed:
August 24, 1995

Court: United States Court of Appeals for the Sixth Circuit

See also:

Counsel for petitioner: Solicitor General

Counsel for respondent: Pikna Jr.,Raymond J.

Entry	Date	Note	Proceedings and Orders
1	Aug 24 1995	G	Petition for writ of certiorari filed.
3	Sep 18 1995		Order extending time to file response to petition until October 23, 1995.
4	Oct 20 1995		Brief of respondent Thomas Noland, Trustee in opposition filed.
5	Nov 1 1995		DISTRIBUTED. November 22, 1995 (Page 1)
6	Nov 7 1995	X	Reply brief of petitioner filed.
8	Nov 27 1995		REDISTRIBUTED. December 1, 1995 (Page 19)
9	Dec 1 1995		Petition GRANTED. The case is set for oral argument in tandem with No. 95-325, United States v. Reorganized CF&I Frabricators of Utah, Inc., et al.
			**********
10	Dec 11 1995	G	Motion of the Solicitor General to dispense with printing the joint appendix filed.
11	Jan 8 1996		Motion of the Solicitor General to dispense with printing the joint appendix GRANTED.
12	Jan 16 1996		Brief of petitioner United States filed.
13	Jan 24 1996		SET FOR ARGUMENT MONDAY, MARCH 25, 1996. (1ST CASE).
14	Jan 29 1996		CIRCULATED.
15	Feb 5 1996		Record filed.
		*	Partial record proceedings United States Court of Appeals for the Sixth Circuit.
16	Feb 5 1996		Record filed.
		*	Original record proceedings United States District Court for the Southern District of Ohio.
17	Feb 20 1996	X	Brief of respondent Thomas R. Noland filed.
18	Mar 13 1996	X	Reply brief of petitioner United States filed.
19	Mar 25 1996		ARGUED.

Supreme Court, U.S.
FILED

95-323 AUG 24 1995

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No.

In the Supreme Court of the United States

OCTOBER TERM, 1995

UNITED STATES OF AMERICA, PETITIONER

v.

THOMAS R. NOLAND, TRUSTEE FOR DEBTOR
FIRST TRUCK LINES, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

DREW S. DAYS, III
Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

KENT L. JONES
Assistant to the Solicitor General

GARY D. GRAY
EDWARD T. PERELMUTER
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 514-2217

QUESTION PRESENTED

Taxes and tax penalties that arise after the date of a bankruptcy filing are "administrative expenses" of the bankruptcy estate. 11 U.S.C. 503(b)(1)(B) and (C). As "administrative expenses," such taxes and tax penalties are entitled to first priority in the distribution of the estate. 11 U.S.C. 507(a)(1). This case presents the following question:

Whether the statutory priority that Congress conferred on the government's claim for post-petition tax penalties may—under the "principles of equitable subordination" codified in Section 510(c)(1) of the Bankruptcy Code, 11 U.S.C. 510(c)(1)—be subordinated to the claims of general unsecured creditors solely because a court determines that it would enhance "fairness" and "justice" to pay the general creditors first.

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In the Supreme Court of the United States

OCTOBER TERM, 1995

No.

UNITED STATES OF AMERICA, PETITIONER

v.

THOMAS R. NOLAND, TRUSTEE FOR DEBTOR
FIRST TRUCK LINES, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-20a) is reported at 48 F.3d 210. The opinion of the district court (App., *infra*, 26a-33a) is unreported. The opinion of the bankruptcy court (App., *infra*, 34a-55a) is reported at 148 B.R. 332.

JURISDICTION

The judgment of the court of appeals was filed on March 2, 1995 (App., *infra*, 23a). A petition for rehearing was denied on June 16, 1995 (App., *infra*, 24a). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

Sections 503(b)(1)(B) and (C), 507(a)(1), 510(c) and 726(a) of the Bankruptcy Code, 11 U.S.C. 503(b)(1)(B) and (C), 507(a)(1), 510(c) and 726(a), are reproduced in the Appendix, *infra*, at 56a-58a.

STATEMENT

1. In 1986, First Truck Lines, Inc., filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code and continued to operate its business as debtor-in-possession. During the following two years, the debtor failed to pay the social security and unemployment taxes accruing from its operations. After efforts to reorganize the debtor proved unsuccessful, the bankruptcy case was converted to a Chapter 7 liquidation in 1988. Respondent was appointed trustee at that time (App., *infra*, 2a).

The Internal Revenue Service filed a request for payment of the taxes, interest and tax penalties that accrued after the filing of the bankruptcy petition. Respondent stipulated that the unpaid postpetition taxes and interest are "administrative expenses" that are entitled to first priority in the distribution of the assets of the estate under Section 507(a)(1) of the Bankruptcy Code, 11 U.S.C. 507(a)(1). Respondent asserted, however, that postpetition tax penalties are

not entitled to priority in distribution. The parties applied to the bankruptcy court for resolution of that dispute (App., *infra*, 2a-3a).

2. The bankruptcy court acknowledged (App., *infra*, 40a) that Section 503(b)(1)(C) of the Bankruptcy Code expressly defines postpetition tax penalties to be "administrative expenses" (11 U.S.C. 507(a)(1)). The court observed, however, that Section 510(c)(1) of the Bankruptcy Code, 11 U.S.C. 510(c)(1), provides that a court may (*ibid.*),

> under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim * * *.

Because Section 510(c)(1) "does not expressly define the phrase 'equitable subordination,'" the court stated that it would "resort to an examination of the legislative history" (App., *infra*, 42a-43a).

At the time the Bankruptcy Code was enacted in 1978, the floor statement of the House sponsor stated (App., *infra*, 43a, quoting 124 Cong. Rec. 32,398 (1978) (Rep. Edwards), and citing 124 Cong. Rec. 33,992, 33,998 (1978) (Sen. DeConcini) (emphasis added by court)):

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if [the] holder of such claim is guilty of inequitable conduct, *or the claim is of a status susceptible to subordination, such as a penalty* or a claim for damages arising from the purchase or sale of a security of the debtor.

The bankruptcy court concluded that this legislative history evidences that Congress intended that a tax "penalty"—like any other "penalty"—would be "susceptible to subordination" under the "principles of equitable subordination" codified in Section 510(c) of the Code (App., *infra*, 43a). The court deemed it irrelevant that in 1978 Congress provided a specific statutory priority for postpetition tax "penalties" (11 U.S.C. 503(b)(1)(C)). The court also found it irrelevant that the United States had not been "guilty of inequitable conduct" in asserting its claim. The court concluded that the government's claim for tax penalties is subject to equitable subordination simply because it is designed to enforce a "penalty" (App., *infra*, 44a).

In applying the "principles of equitable subordination" codified in Section 510(c)(1) of the Bankruptcy Code, the court stated that its task is to "weigh the equities of the various claims on a case-by-case basis" to determine whether subordination is appropriate (App., *infra*, 44a). The court began its "weighing" or "balancing" of "the equities" by distinguishing between the pecuniary losses incurred by general commercial creditors and the nonpecuniary loss represented by statutory tax penalties. Finding that the Bankruptcy Code contains a "preference for compensating actual loss claims," the court held "that the equities tilt in favor of subordinating the postpetition nonpecuniary loss tax penalties sought by the IRS" to "the claims of general unsecured creditors of the debtor" (*id.* at 49a-50a). Otherwise, the court noted, the assets available for payment of the general unsecured creditors would be reduced by the amount of the tax penalties that, by statute, were given first

priority in distribution as administrative expenses of the estate (*ibid.*).

3. The district court affirmed (App., *infra*, 26a-33a). The court stated that all types of priority claims—including first priority claims for administrative expenses—may be subordinated under the "principles of equitable subordination" that Congress codified in Section 510(c) of the Bankruptcy Code (App., *infra*, 29a). The court agreed with the bankruptcy court that the "principles of equitable subordination" are not restricted to remedying inequitable misconduct by creditors. The court held, instead, that the "principles of equitable subordination" permit a tax "penalty" to be subordinated solely in order to promote the priority of the claims of other creditors who suffered pecuniary losses from their dealings with the estate (*id.* at 32a-33a).

The district court emphasized that "other creditors * * * provided value to [the debtor] and will not receive that for which they bargained if the IRS is to be given priority for sums which do not represent out of pocket losses to it" (App., *infra*, 33a). For this reason, the court concluded that "the equities tip in favor of subordinating the IRS's claim for tax penalties in this case" (*ibid.*).

4. a. The court of appeals affirmed (App., *infra*, 1a-20a). The court noted that this Court has applied "principles of equitable subordination" in bankruptcy cases only in situations involving "creditor misconduct" (App., *infra*, 5a, citing *Comstock* v. *Group of Institutional Investors*, 335 U.S. 211 (1948); *Pepper* v. *Litton*, 308 U.S. 295 (1939); *Taylor* v. *Standard Gas & Electric Co.*, 306 U.S. 307 (1939)). The court also noted that, in *United States*

v. *Mansfield Tire & Rubber Co.*, 942 F.2d 1055 (1991), cert. denied, 502 U.S. 1092 (1992), another panel of that circuit held that the government's claim for prepetition excise tax liabilities—which have *seventh* priority in distribution under Section 507(a)(7) of the Bankruptcy Code—is *not* subject to equitable subordination solely in order to improve the "fairness" of the distribution to other creditors (App., *infra*, 5a-6a). The court held, however, that none of these decisions is controlling in the context of this case, which concerns the application of "principles of equitable subordination" to a tax "penalty" (*id.* at 6a).

The court of appeals followed the analysis of the bankruptcy court in concluding that the legislative history of Section 510(c) indicates that a statutory "penalty" is properly subject to equitable subordination. The court noted that the floor statement of the House sponsor of the 1978 Bankruptcy Reform Act reflected that Congress intended to "follow existing case law and leave to the courts development of this principle" (App., *infra*, 11a, quoting 124 Cong. Rec. at 32,398 (Rep. Edwards)). The court acknowledged that there was no "existing case law" as of 1978 that supported the equitable subordination of priority tax penalty claims. The court ascribed this, however, to the fact that, "prior to 1978, nonpecuniary loss tax penalty claims against the estate of the bankrupt were not allowed by law" (App., *infra*, 12a). The court noted that three more recent decisions have held that claims for *pre*petition *non*priority tax penalties may be equitably subordinated even though no governmental misconduct occurred (*id.* at 14a, citing *Burden* v. *United States*, 917 F.2d 115, 119-120 (3d Cir. 1990), *In re Virtual Network Services Corp.*, 902 F.2d 1246, 1248-1250 (7th Cir. 1990), and *Schultz Broadway Inn* v. *United States*, 912 F.2d 230, 232-234 (8th Cir. 1990)). The court stated that the reasoning of those decisions applied directly to this case (App., *infra*, 19a):

> We do not see the fairness or the justice in permitting the Commissioner's claim for tax penalties, which are not being assessed because of pecuniary losses to the Internal Revenue Service, to enjoy an equal or higher priority with claims based on the extension of value to the debtor, whether secured or not. Further, assessing tax penalties against the estate of a debtor no longer in existence serves no punitive purpose. Because of the nature of postpetition, nonpecuniary loss tax penalty claims in a Chapter 7 case, we believe such claims are susceptible to subordination. To hold otherwise would be to allow creditors who have supported the business during its attempt to reorganize to be penalized once that effort has failed and there is not enough to go around. Furthermore, to hold otherwise could result in rewarding the debtor-in-possession, the party who failed to pay the taxes on time, to the detriment of the creditors. The debtor-in-possession remains liable individually for the postpetition tax penalties. However, if the bankruptcy court cannot subordinate these penalties in the appropriate case, the creditors, and not the debtor-in-possession, will have borne the burden of paying the penalties.

b. Judge Batchelder filed a concurring opinion (App., *infra*, 21a-22a). She stated that the court had correctly determined that the "principles of equitable subordination" permit subordination of priority tax claims. In her view, the plain language

of the statute mandates that conclusion and "nothing requires us to delve into the legislative history" (*id.* at 22a):

> Section 726(a) explicitly, clearly, and unambiguously makes the distribution of the property of the estate subject to the provisions of § 510. Postpetition nonpecuniary loss tax penalties are therefore subject to equitable subordination. End of story.

REASONS FOR GRANTING THE PETITION

The court of appeals held in this case that postpetition tax penalties are not to be given the *first* priority that Congress expressly provided for such claims in Sections 503(b)(1)(C) and 507(a)(7) of the Bankruptcy Code. The court held that claims for such penalties are instead to be denied *any* priority and are to be subordinated to general unsecured claims against the debtor. The court stated that its conclusion results from application of the judge-made "principles of equitable subordination" that Congress codified in Section 510(c) of the Bankruptcy Code.

By holding that a tax "penalty" is to be subordinated to all other claims, the decision in this case annuls and reverses the precisely opposite set of statutory priorities that Congress enacted. The decision thereby conflicts with the established rule that equitable subordination in bankruptcy does *not* permit a court "to contradict statutory or common law when [it] feels a fairer result may be obtained by application of a different rule" (*Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d 784, 787 (9th Cir.), cert. denied, 423 U.S. 913 (1975)). The doctrine of equitable subordination does not confer a power of statutory nullification on the bankruptcy courts. Instead,

as this Court's decisions reflect, the doctrine has a far narrower and more appropriate role. Its function is to deter "conduct either in acquiring or asserting the claim which is itself inequitable" (*ibid.*). That traditional rationale obviously would not justify subordination of the tax penalty claims in this case.

By assuming a broad authority to realign statutory priorities based upon a "weighing" or "balancing" of the "equities," the court of appeals has seriously misapplied the judge-made doctrine of "equitable subordination" and unloosened that doctrine from its proper moorings. If courts are permitted to determine, on a case-by-case analysis of the "balance of the equities," whose claims are to be paid first and whose are to be paid last, the carefully constructed scheme of priorities established in the Bankruptcy Code would be made superfluous.

The decision in this case has broad recurring significance. The conclusion that a prescribed tax penalty is to be subordinated to all other claims against the debtor has obvious significance for tax enforcement. Indeed, as this Court recognized in *Nicholas* v. *United States*, 384 U.S. 678, 694 (1966), Congress enacted the priority for postpetition tax penalties precisely because such penalties are an important and necessary measure for ensuring tax compliance in bankruptcy cases.

The court's rationale that, because tax penalty claims do not compensate for pecuniary loss, they should be equitably subordinated to the claims of "creditors who suffered actual losses," as a matter of "fairness" (App., *infra*, 19a), places in question not merely the priority of tax penalties. It will spawn litigation over whether claims for other types

of governmental penalties, punitive damages, liquidated damages and other non-compensatory damages may be "equitably" subordinated simply because those claims do not involve an outlay of funds that extended "value to the debtor" (*ibid.*).

Because the courts of appeals are in conflict in their understanding and application of the judge-made doctrine of "equitable subordination," and because of the importance of the issue presented, review by this Court of the decision in this case is warranted.[1]

1. a. A postpetition tax penalty is defined by statute to be an "administrative expense" of the bankruptcy estate. 11 U.S.C. 503(b)(1)(C). As an "administrative expense," such a penalty has "[f]irst" priority in the distribution of the assets of the estate. 11 U.S.C. 507(a)(1). See also 11 U.S.C. 726(a)(1).

The priorities that Congress established in the Bankruptcy Code apply "[e]xcept as provided in section 510" of the Code. 11 U.S.C. 726(a). Section 510 authorizes only three specific exceptions to the statutory ordering of priorities. First, any claim may be subordinated by agreement. 11 U.S.C. 510(a). Second, claims seeking rescission or damages from sales of the debtor's securities may be subordinated. 11 U.S.C. 510(b). Third, any claim may be subordinated to any other claim "under principles of equitable subordination * * *." 11 U.S.C. 510(c). The question presented in this case is thus not whether "principles of equitable subordination" *may* be applied to priority claims; instead, it is *what* those principles are and *how* they are to be applied to priority claims.

[1] The United States is concurrently filing a petition for a writ of certiorari to review the decision of the Tenth Circuit in *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, 53 F.3d 1155 (1995), which presents issues closely related to those of the present case. If, as we urge, both petitions are granted, we suggest that the two cases be set for argument in tandem.

We have furnished a copy of the petition in *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.* to counsel for respondents in this case. We have also furnished a copy of the petition in this case to counsel for respondents in *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*

b. The judge-made doctrine of equitable subordination has a clear origin and a limited scope (*In re Columbia Ribbon Co.*, 117 F.2d 999, 1002 (3d Cir. 1941)):

> [A] court of bankruptcy under its equitable powers may disallow or subordinate a particular claim in bankruptcy which, because of the fraudulent nature of the claim or the bad faith or improper conduct of the claimant, ought not in equity and good conscience to be allowed or paid on a parity with other claims.

See also *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d 784, 788 (9th Cir.), cert. denied, 423 U.S. 913 (1975). The issue that is to be resolved "under principles of equitable subordination" is whether (2 Collier Bankruptcy Manual ¶ 510.01[1], at 510-2 (3d ed. 1995)):

> harmful conduct [of the claimant] was directed at other creditors. If it was, the claim which is otherwise provable and allowable should be postponed until the claims of the creditors, who were harmed, have been satisfied.

See *Comstock* v. *Group of Institutional Investors*, 335 U.S. 211, 229 (1948); *Pepper* v. *Litton*, 308 U.S. 295, 311 (1939); *Taylor* v. *Standard Gas & Electric*

Co., 306 U.S. 307, 323 (1939); Herzog & Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 Vand. L. Rev. 83, 85 (1961).

The doctrine of equitable subordination thus provides a means to redress harmful misconduct of an individual claimant.[2] The doctrine does not, however, authorize a court to disregard statutory priorities merely because the court concludes that it would be more "fair"—or would somehow be better policy—to adopt a different distribution scheme. "[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 206 (1988). As the Ninth Circuit explained in *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 787:

> [I]t is important to keep in mind that the chancellor never did, and does not now, exercise unrestricted power to contradict statutory or common law when he feels a fairer result may be obtained by application of a different rule. Courts of equity have long applied standards of conscience to conduct on an individual basis to prevent formally proper but unconscionable applications of legal rules; they have not engaged in the practice of making abstract legislative judgments about the fairness of a result contemplated by the legislature's statutory scheme if it has otherwise been followed in good faith and without overreaching.

See also *In re Columbia Ribbon Co.*, 117 F.2d at 1002.[3]

In enacting the statutory priority scheme, Congress itself made a "reasonable classification of claims as entitled to priority because of superior equities" (*Carpenter* v. *Wabash Ry.*, 309 U.S. 23, 28 (1940)). The categorical balancing of equities that Congress made in adopting the Code's priority provisions may not categorically be displaced by the courts under the guise of "equitable subordination." As the Ninth Circuit stated in *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 788, the doctrine of equitable subordination does not permit a court to say, "in effect * * *, 'No, the distribution scheme provided by the [Bankruptcy] Act is a mistake * * *.'"

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[2] The underlying premise of any application of the doctrine of "equitable subordination" to "creditor misconduct" is that Congress has measured the equities of competing classes of claims but has not measured the conduct of the individual creditors who assert those claims. See *Carpenter* v. *Wabash Ry.*, 309 U.S. 23, 28 (1940). Because Congress did not (and indeed cannot) take the conduct of individual creditors into account in enacting a bankruptcy distribution scheme, subordination of a particular claim based upon the inequitable conduct of the specific creditor does not contravene the legislative judgment concerning the relative equities of the various classes of claims in general. See *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 787.

[3] Similarly, in *New Jersey* v. *Anderson*, 203 U.S. 483 (1906), the Court rejected the assertion that a statutory priority for state taxes should not be recognized because it created an "injustice" for other creditors and gave the State an undue "advantage" (*id.* at 490):

> [C]onsiderations of this character, however properly addressed to the legislative branch of the government, can have no place in influencing judicial determination. It is the province of the court to enforce, not to make the laws, and if the law works inequality the redress, if any, must be had from Congress.

The decision in the present case ultimately reflects an implicit policy judgment by the courts below that Congress somehow erred or acted "unfairly" in awarding first priority to the government's claims for postpetition tax penalties under Section 503(b)(1)(C) and Section 507(a)(1).[4] Even if there were a basis to believe that it might be more "fair" to pay other creditors before postpetition tax penalties are paid, any dispute about the relative merits of alternative priority schemes is simply irrelevant to the task that the court of appeals properly had before it. Congress authoritatively resolved that policy issue when it expressly provided a first priority for postpetition tax penalty claims in 11 U.S.C. 503(b)(1)(C). As this Court explained in enforcing the priority for postpetition tax penalties in *Nicholas* v. *United States*, 384 U.S. at 694, Congress adopted that priority precisely because penalties are an important and "legitimate means to enforce" compliance with the tax laws in bankruptcy cases. See also *Boteler* v. *Ingels*, 308 U.S. 57, 61 (1939).[5] By in-

[4] While Section 726(a)(1) preserves first priority in distribution for postpetition tax penalties, Section 726(a)(4) expressly subordinates prepetition tax penalties to general unsecured claims. Compare 11 U.S.C. 726(a)(1) with 11 U.S.C. 726(a)(4). The reasoning adopted by the courts below is thus invalid for the additional reason that it deprives the carefully crafted distinctions made by Congress in enacting Section 726 of any force.

[5] The court of appeals erred in relying on the suggestion of Representative Edwards that "existing case law" permits subordination of "a claim * * * of a status susceptible to subordination, such as a penalty * * *" (App., *infra*, 11a). Whatever "penalty" Representative Edwards may have had in mind in making that assertion, he obviously was not

voking "equitable subordination" as authority for annulling the categorical priorities that Congress enacted, the decision in this case conflicts with the deci-

contemplating that postpetition tax penalty claims would be subordinated under Section 510(c)(1) when Section 503(b)(1)(C) of the *same* Act provides "[f]irst" priority for such claims. See 11 U.S.C. 503(b)(1)(C). Indeed, Representative Edwards went on to say in the next portion of his remarks (124 Cong. Rec. at 32,416c):

> Since the House amendment authorizes subordination of claims only under principles of equitable subordination, and thus incorporates principles of existing case law, a tax claim would rarely be subordinated under this provision of the bill.

See also 124 Cong. Rec. 33,998, 34,016 (1978) (Sen. DeConcini).

It is also apparent that, in suggesting that "penalty" claims are subject to subordination, the floor statement of Representative Edwards did not accurately describe "existing case law." Neither prepetition nor postpetition governmental penalties were subordinated under "existing case law" in 1978. Claims for prepetition penalties were disallowed (not subordinated) under Bankruptcy Act § 57j, 11 U.S.C. 93(j) (1976). See *Simonson* v. *Granquist*, 369 U.S. 38, 40 (1962). Claims for *post*petition penalties incurred by the trustee or debtor-in-possession were allowable, however, and were entitled to first priority in distribution of the bankruptcy estate. *Nicholas* v. *United States*, 384 U.S. 678, 692-695 (1966); *Boteler* v. *Ingels*, 308 U.S. 57, 61 (1939); *United States* v. *New York Creditmen's Adjustment Bureau, Inc.*, 394 F.2d 340, 341-342 (2d Cir. 1968).

The majority and concurring opinions in this case (App., *infra*, 12a-13a, 22a) thus erred in stating, without qualification, that penalty claims were disallowed under the former Bankruptcy Act. There also was no "existing case law" subordinating or disallowing postpetition penalty claims based upon their "status." See *Burden* v. *United States*, 917 F.2d 115, 123 (3d Cir. 1990) (Alito, J., concurring in part and

sion of the Ninth Circuit in *Stebbins* and with the long line of cases holding that "[d]ecisions about the treatment of *categories* of claims in bankruptcy proceedings * * * are not dictated or illuminated by principles of equity and do not fall within the judicial power of equitable subordination * * *." *Burden* v. *United States*, 917 F.2d at 122 (Alito, J., concurring in part and dissenting in part; emphasis added).[6] See, *e.g.*, *Benjamin* v. *Diamond*, 563 F.2d 693, 700

dissenting in part). Any misdescription of "existing case law" contained in the 1978 floor statement of Representative Edwards obviously could not alter the "principles of equitable subordination" that the courts had developed and that are to be applied under Section 510(c)(1).

[6] The Third Circuit has placed itself on both sides of this issue. In 1941, the court explained that the doctrine of equitable subordination does not authorize a court to adopt a priority scheme different from the statutory scheme based simply upon the court's "theory of equity." *In re Columbia Ribbon Co.*, 117 F.2d at 1002. Instead, the court explained, equitable subordination may be applied to "disallow or subordinate a particular claim in bankruptcy which, because of the fraudulent nature of the claim or the bad faith or improper conduct of the claimant, ought not in equity and good conscience to be allowed or paid on a parity with other claims." *Ibid.*

In 1990, the Third Circuit acknowledged that "prior to the enactment of the Bankruptcy Act of 1978," the doctrine of equitable subordination had applied "only when there has been a showing of bad faith on the part of the creditor." *Burden* v. *United States*, 917 F.2d at 119. The court identified nothing in the text or history of the 1978 legislation to justify a departure from that historical understanding of equitable subordination. The court stated, however, that it was "persuaded" by several recent decisions holding that "creditor misconduct is not a prerequisite for equitable subordination."

(5th Cir. 1977) (equitable subordination requires that "[t]he claimant must have engaged in some type of inequitable conduct"); *In re Credit Industrial Corp.*, 366 F.2d 402, 408 (2d Cir. 1966); *United States* v. *Killoren*, 119 F.2d 364, 366 (8th Cir. 1941) (reversing "equitable subordination" of a claim for taxes, for "[t]he plain mandate of the law cannot be set aside because of considerations which may appeal to referee or judge as falling within general principles of equity jurisprudence").

c. In 1978, Congress codified the judge-made doctrine of equitable subordination as Section 510(c)(1) of the Bankruptcy Code. That provision states that bankruptcy courts may, "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim * * *." 11 U.S.C. 510(c)(1).

That statute did not enlarge the authority that courts had previously exercised. As the 1978 floor statement quoted by the court of appeals emphasizes, Congress "intended that the term 'principles of equitable subordination' follow existing case law and leave to the courts development of this principle" (App., *infra*, 11a, quoting 124 Cong. Rec. 32,398 (Rep. Edwards)).

The emphasis in the 1978 floor statement that "existing case law" is to be followed in applying "principles of equitable subordination" reflects a deliberate policy determination that Congress made at that time. In enacting the 1978 Act, Congress con-

Id. at 120-121. As described in the text, Judge Alito dissented from that part of the court's opinion.

sidered and rejected statutory language that would have granted bankruptcy courts authority to subordinate claims on much broader grounds. The bill that first passed the House of Representatives contained a version of Section 510(c) that would have allowed any claim to be subordinated simply "on equitable grounds." H.R. 8200, 95th Cong., 1st Sess., § 510 (1977). The report accompanying the House bill emphasized that this language differed from the existing doctrine of equitable subordination, for it would permit the courts to order "subordination on any equitable grounds." H.R. Rep. No. 595, 95th Cong., 1st Sess. 359 (1977). The broad language of the House bill was deleted, however, from the final legislation. The phrase "under principles of equitable subordination" was substituted in its place. See S. Rep. No. 989, 95th Cong., 2d Sess. 74 (1978); 124 Cong. Rec. 32,416 (1978) (Rep. Edwards); 124 Cong. Rec. 34,016 (1978) (Sen DeConcini).

The history of Section 510(c) thus reflects that Congress consciously elected to adopt only the "existing" principles of equitable subordination and rejected a broader equitable authority for the bankruptcy courts. In the present case, however, the court of appeals declined to follow the "existing case law" that had squarely held that "equitable subordination" may not be applied categorically to reorder statutory priorities. By refusing to apply that "existing case law," the court of appeals placed itself in conflict with the decisions of the Fifth and Ninth Circuits in *Benjamin* v. *Diamond* and *Stebbins* v. *Crocker Citizens National Bank*. See also *In re Credit Industrial Corp.*, 366 F.2d at 408; 3 *Collier on Bankruptcy*

¶ 510.01 (15th ed. 1995) ("The law in this area is of long standing, having been judicially created").

d. The conflict among the courts of appeals concerning the proper scope of the doctrine of equitable subordination has recently become pronounced. In conflict with the decisions of the Fifth Circuit in *Benjamin* and the Ninth Circuit in *Stebbins*—as well as the earlier decisions of the Third Circuit in *In re Columbia Ribbon Co.* and the Eighth Circuit in *Killoren*—the Third, Seventh, Eighth and Tenth Circuits have joined the Sixth Circuit in holding that "principles of equitable subordination" are *not* confined to remedying creditor misconduct and instead permit courts categorically to subordinate "penalty" claims to the claims of other creditors who have incurred an "actual loss" (App., *infra*, 20a). See *Burden* v. *United States*, 917 F.2d 115, 119-120 (3d Cir. 1990); *In re Virtual Network Services Corp.*, 902 F.2d 1246, 1248-1250 (7th Cir. 1990); *Schultz Broadway Inn* v. *United States*, 912 F.2d 230, 232-234 (8th Cir. 1990); *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, 53 F.3d 1155, 1158 (10th Cir. 1995).[7]

[7] These cases from the Third, Seventh, Eighth and Tenth Circuits all involve the subordination of nonpriority tax penalty claims in cases under Chapters 11 and 13, rather than Chapter 7, of the Bankruptcy Code. As we have noted (note 4, *supra*), in Chapter 7 cases, Congress expressly provided priority for postpetition tax penalty claims and subordinated only prepetition tax penalty claims. Compare 11 U.S.C. 726(a)(4). No similar provision subordinates prepetition penalty claims in cases under other chapters. Indeed, Congress rejected proposals that would have required subordination of prepetition tax penalty claims in cases under all chapters. See *Report of the Commission on the Bankruptcy Laws of the United States*, H.R. Doc. No. 137, 93d Cong., 1st Sess. Pt. II, at 115, § 4-406(a)(3) (1973).

These courts, like the Sixth Circuit in this case, concluded that equitable subordination of a tax penalty claim is appropriate to ensure that payment of the penalty does not reduce the assets available for other claims.

In so holding, these courts acknowledged that, prior to enactment of the Bankruptcy Code in 1978, the "existing case law" had held that the doctrine of equitable subordination requires a showing of creditor misconduct. See, *e.g.*, *In re Virtual Network Services Corp.*, 902 F.2d at 1248, citing *Pepper* v. *Litton*, 308 U.S. at 304-305. The courts also recognized that Congress intended such "existing case law" to apply in any future elaboration of the "principles of equitable subordination" (902 F.2d at 1248; App., *infra*, 11a). They reasoned, however, that the history of the 1978 Act indicates that such older authority is not necessarily binding because "Congress intended courts to continue developing the principles of equitable subordination." *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, 53 F.3d at 1158, citing *In re Virtual Network Services Corp.*, 902 F.2d at 1249-1250.

As evidence of the "developing" principles of equitable subordination, the courts noted that, in *In re Stirling Homex Corp.*, 579 F.2d 206 (1978), the Second Circuit held that the claims of shareholders who alleged that they were defrauded in purchasing stock of the debtor should be equitably subordinated—even in the absence of any creditor misconduct.[8] The courts

[8] *In re Stirling Homex Corp.* involved an attempt by equity shareholders who allegedly were defrauded in the purchase of the debtor's securities to *elevate* their priority in the corporate bankruptcy from last priority (as equity holders) to that of unsecured creditors (as tort claimants). The court subordinated the shareholders' claims to the claims of general unsecured creditors because "the equities favor the conventional general unsecured creditors rather than the allegedly defrauded stockholders." 579 F.2d at 213.

The decision in *Stirling Homex* did not constitute a startling departure from the "existing case law," as some of the courts of appeals have assumed. Instead, that decision appears to represent an application of a settled rule described in the prior decision of the Second Circuit in *In re Credit Industrial Corp.*, 366 F.2d at 408-409 (emphasis added):

> Equitable subordination, which is founded upon estoppel, is the doctrine invoked by courts to deny equal treatment to creditors based on some inequitable or unconscionable conduct in which they have engaged, *or a special position which they occupy vis-a-vis the bankrupt that justifies subordination of their claims.*

That particular application of the principles of equitable subordination can be traced to this Court's decision in *Pepper* v. *Litton*, 308 U.S. 295 (1939). See *In re Credit Industrial Corp.*, 366 F.2d at 409.

Nothing in *Stirling Homex* provides support for the proposition that courts may apply "equitable subordination" categorically to annul the priority classification schemes that Congress enacted. Indeed, the rule that the Second Circuit applied to shareholder claims in *Stirling Homex* was codified in 1978 as subsection Section 510(b) of the Bankruptcy Code (11 U.S.C. 510(b)), which the 1978 floor statement of Representative Edwards described as an example of "existing case law." See App., *infra*, 11a.

concluded that, under this "developing" principle (but see note 8, *supra*), equitable subordination should be based on a "case-by-case" evaluation of the equities and should no longer require proof of creditor misconduct (*United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, 53 F.3d at 1159, quoting

In re Virtual Network Services Corp., 902 F.2d at 1250):

> [Section] 510(c)(1) authorizes courts to equitably subordinate claims to other claims on a case-by-case basis without requiring in every instance inequitable conduct on the part of the creditor claiming parity among other unsecured general creditors.

In the absence of creditor misconduct, however, the doctrine of equitable subordination does not authorize the "case-by-case" balancing of equities that these courts have upheld. In particular, equitable subordination does not authorize judicial disregard of the categorical priorities that Congress has enacted; nor does it authorize judicial nullification of the statutory priority scheme. By reaching the opposite conclusion in this case, the decision of the court of appeals has enlarged the developing conflict and has ignored the inherent limitations of any court sitting in "equity." See *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 787: ([T]he chancellor never did, and does not now, exercise unrestricted power to contradict statutory or common law when he feels a fairer result may be obtained by application of a different rule.).

3. The proper scope of the doctrine of equitable subordination is a matter of substantial recurring importance. The decision in this case has significance not only for the enforcement of federal, state and local tax laws but also for the enforcement of many other types of governmental programs. For example, under the rationale applied by the court of appeals

in this case, penalties designed to enforce federal and state health and safety regulations presumably would also be subject to "equitable subordination" to the claims of the general unsecured creditors who incurred an "actual loss" in their dealings with the estate (App., *infra*, 20a).

Commentators have further noted that the "case-by-case" evaluation of the "equities" of each claimant that these decisions authorize creates harmful uncertainties for private creditors as well. The unfettered equitable authority assumed in these decisions has threatened "the financial community [by calling] into question the future of bankruptcy priority." See Note, *No Fault Equitable Subordination: Reassuring Investors That Only Government Penalty Claims Are At Risk*, 34 Wm. & Mary L. Rev. 487, 488 (1993).[9]

By effectively ensuring that claims for postpetition penalties will not be paid from the assets of bankruptcy estates, the decision in this case would allow debtors-in-possession to disregard their legal obligations with impunity.[10] Allowing violations of the law

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[9] Under a case-by-case evaluation of the "equities" of each competing, innocent claim, it is not possible to be certain whether, for example, claims for punitive damages would be regarded as "inequitable" (because not involving "actual losses") or "equitable" (because designed to promote the public purpose of deterring malicious behavior). See *In re Colin*, 44 B.R. 806, 810 (Bankr. S.D.N.Y. 1984).

[10] The court of appeals erred in suggesting (App., *infra*, 19a) that the tax penalties involved in this case can be collected by the government even if that claim is subordinated in the liquidation proceedings. The court reasoned that ultimate collection is assured because the "debtor in possession remains liable individually for the postpetition tax penalties"

to go unsanctioned—and undeterred—is neither "fair," nor "equitable," nor good "policy." As this Court recognized in *Boteler* v. *Ingels*, 308 U.S. 57, 61 (1939), and *Nicholas* v. *United States*, 384 U.S. 678, 694 (1966), the priority for postpetition penalties in bankruptcy exists for the very purposes of ensuring that debtors abide by the same rules of law that apply to every other business. See also *United States Department of Interior* v. *Elliott*, 761 F.2d 168, 171 (4th Cir. 1985).[11] In any event, as we have noted and as other circuits have held, the doctrine of equitable subordination does not authorize a "reweighing" of the balance of equities that Congress itself struck in providing the statutory priority for postpetition tax penalty claims.

(*ibid.*). In making that statement, however, the court seems to have forgotten that this case involves a liquidation under Chapter 7. After such a liquidation, the debtor will have no assets available to pay any unsatisfied, subordinated tax penalty claim.

[11] In *United States Dep't of Interior* v. *Elliott*, the court explained why priority is granted to claims for postpetition penalties even though such claims may deplete the assets available to other creditors. Creditors may influence the debtor in possession or trustee to prevent the accrual of such penalties and should not be permitted to benefit from the false economies recognized by the estate through its failure to comply with applicable nonbankruptcy law. 761 F.2d at 171.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

DREW S. DAYS, III
Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

KENT L. JONES
Assistant to the Solicitor General

GARY D. GRAY
EDWARD T. PERELMUTER
Attorneys

AUGUST 1995

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

No. 93-4311

IN RE: FIRST TRUCK LINES, INC., DEBTOR

UNITED STATES OF AMERICA, APPELLANT

v.

THOMAS R. NOLAND, Trustee, APPELLEE

On Appeal from the United States District Court
for the Southern District of Ohio

Decided and Filed March 2, 1995

Before: MARTIN and BATCHELDER, Circuit Judges; and ENSLEN, District Judge.*

MARTIN, J., delivered the opinion of the court, in which ENSLEN, D.J., joined. BATCHELDER, J. (pp. 18-19), delivered a separate concurring opinion.

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* The Honorable Richard A. Enslen, United States District Judge for the Western District of Michigan, sitting by designation.

BOYCE F. MARTIN, JR., Circuit Judge. We have before us an appeal of the bankruptcy court's decision to equitably subordinate the Commissioner of Internal Revenue Service's claim for postpetition, nonpecuniary loss tax penalties to the claims of general unsecured creditors. For the following reasons we affirm the decision of the district court.

The debtor in this case, First Truck Lines, Inc., voluntarily filed for relief under Chapter 11 of the Bankruptcy Code on April 10, 1986. During the postpetition operation of its business, the debtor-in-possession did not pay to the Internal Revenue Service accrued Federal Insurance Contributions Act and Federal Unemployment Tax Act taxes. In June 1988, the debtor moved to convert the case to a Chapter 7 bankruptcy, and the bankruptcy court ordered conversion on August 1, 1988. Thomas R. Noland was appointed the Trustee. The debtor ceased operations thereafter, and liquidation of the estate assets did not produce sufficient funds to pay all creditors in full. The bar date for filing claims under Chapter 7 was December 1, 1988.

On November 22, 1988, the Internal Revenue Service filed a "Request for Payment of Administrative Expenses" claim ("Claim 102"). Claim 102 was comprised of accrued postpetition, preconversion taxes, interest, and penalties. On April 20, 1989, the Internal Revenue Service filed an additional "Request for Payment of Administrative Expenses" claim ("Claim 107"), amending Claim 102. The bankruptcy court permitted Claim 107 to partially amend Claim 102, adding a penalty for postpetition, unpaid Federal Unemployment Tax Act taxes.

Once litigation commenced, the Commissioner and the Trustee stipulated that the tax and interest portion of Claim 102, but not the tax penalty portion, were administrative expenses with priority under 11 U.S.C. §§ 726(a)(1), 507 (a)(1), and 503(b)(1) (1988). We take this stipulation to mean that all taxes and interest were in fact given a priority in the bankruptcy estate. The issue before the bankruptcy court, then, was whether administrative expense priority should be accorded to the postpetition tax penalties. The bankruptcy court held that, although postpetition tax, interest, *and penalties* were "administrative expenses" pursuant to 11 U.S.C. § 503 (b), the tax penalties were subject to the court's equitable subordination powers under 11 U.S.C. § 510(c) (1988). The court then interpreted and applied its powers of equitable subordination to include the ability to subordinate a claim, not only in the case of creditor misconduct, but also in the case of postpetition, nonpecuniary loss tax penalties. In balancing the equities, the bankruptcy court reasoned that the Bankruptcy Code exhibited a preference for compensating actual losses, especially in a liquidation proceeding. Furthermore, the bankruptcy court reasoned that, unlike business creditors who had surrendered a valuable asset to the debtor, the United States had not suffered an actual pecuniary loss with regard to the penalties. The bankruptcy court concluded that the equities of the case required subordination of the Commissioner's tax penalty claim to the claims of general unsecured creditors. The district court agreed.

The central issue in this appeal is whether a bankruptcy court may, in a Chapter 7 case, equitably subordinate postpetition, nonpecuniary loss tax penalties to any other claim, including the claims of general unsecured creditors, in the absence of creditor mis-

conduct: here, in the absence of misconduct by the Commissioner. No other Circuit has addressed this precise issue, although three other Circuits have determined that *prepetition*, nonpecuniary loss tax penalty claims could be equitably subordinated even in the absence of creditor misconduct. *Burden v. United States*, 917 F.2d 115 (3d Cir. 1990) (Chapter 13 case); *Schultz Broadway Inn v. United States*, 912 F.2d 230 (8th Cir. 1990) (liquidating Chapter 11 case); *In re Virtual Network Servs. Corp.*, 902 F.2d 1246 (7th Cir. 1990) (liquidating Chapter 11 case). Should we decide that *postpetition*, nonpecuniary loss tax penalty claims are also subject to equitable subordination in a Chapter 7 case even in the absence of creditor misconduct, we must also decide whether the bankruptcy court properly subordinated the tax penalty claim in this case.

The Commissioner argues that the bankruptcy court does not have the power to equitably subordinate the postpetition tax penalties in Claim 102 to the claims of general unsecured creditors. The Commissioner's primary assertion is that Congress has already balanced the equities with regard to postpetition tax penalty claims in a Chapter 7 case and has expressly awarded administrative expense priority to claims for postpetition taxes, interest *and penalties* under 11 U.S.C. §§ 726(a)(1), 507(a)(1), and 503(b)(1)(B) and (C). The Commissioner contends that Congress was well aware that tax penalties, by their nature, are not related to the giving of value to the debtor. Thus, knowing that the only colorable argument that can be made for equitably subordinating postpetition, nonpecuniary loss tax penalty claims is that it is unfair and unjust to award the government higher priority for a claim

not based on the extension of value to the debtor, Congress still gave tax penalties administrative expense priority. The argument continues that a bankruptcy court may not, based on the same equitable ground, disregard the will of Congress and grant equitable relief to general unsecured creditors by subordinating the tax penalty claim. The Commissioner concludes that the principles of equitable subordination enable a bankruptcy court to subordinate a postpetition tax penalty claim only in the presence of misconduct.

In support of this position, the Commissioner relies on our decision in *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055 (6th Cir. 1991), *cert. denied*, 112 S. Ct. 1165 (1992), and on pre-1978 Supreme Court cases permitting equitable subordination of claims because of creditor misconduct. *See Comstock v. Group of Institutional Investors*, 335 U.S. 211 (1948); *Pepper v. Litton*, 308 U.S. 295 (1939); *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939). The Commissioner argues that our decision in *Mansfield Tire* requires us to reverse the district court. The Commissioner construes *Mansfield Tire* as expressly rejecting the proposition that bankruptcy courts may employ equitable subordination to override Congress's priority scheme based on the court's own view of equity. *Id.* at 1062. The view of the Commissioner, while partially correct, constitutes an incomplete understanding of *Mansfield Tire*. This Court also said in *Mansfield Tire* that, while a bankruptcy court may not impose its own view of equity where Congress has set priorities, Section 510(c) expressly permits a bankruptcy court to apply the "principles of equitable subordination" to subordinate a claim "otherwise susceptible to subordination, such as a penalty."

Mansfield Tire, 942 F.2d at 1062 (citing 1978 U.S.C.C.A.N. 5787, 6452 (statement of Rep. Edwards); 1978 U.S.C.C.A.N. 6505, 6521 (statement of Sen. DeConcini)). In *Mansfield Tire*, we decided only whether a claim for an excise tax was the type of claim susceptible to subordination, and not whether a tax penalty claim was susceptible to subordination. As to the Supreme Court cases cited above, these do not address the precise question this Court must answer and do not preclude our holding that equitable subordination may be proper even in the absence of creditor misconduct.

The Trustee and the Commissioner agree that Congress has given postpetition tax penalties first priority as administrative expenses in a Chapter 7 case. 11 U.S.C. §§ 726(a)(1), 507(a)(1), 503(b)(1)(C). This Court, in the case of *In re Flo-Lizer, Inc.*, 916 F.2d 363, 366 (6th Cir. 1990), reached the same conclusion, but we did not discuss the relationship between Section 510(c) and Section 503(b). Although the parties agree as to the priority of postpetition, nonpecuniary loss tax penalty claims, the parties disagree as to the effect of Section 510(c) on the tax penalty claim. The Trustee argues that the statutory treatment of a postpetition tax penalty as an administrative expense does not necessarily mean that the claim cannot be equitably subordinated under Section 510(c). The trustee contends that 11 U.S.C. § 726(a)(1) provides that all Chapter 7 distributions are subject to Section 510(c), and that Section 510(c), in turn, permits equitable subordination in the appropriate case. The Trustee then relies on our opinion in *Mansfield Tire* for the proposition that tax penalties are subject to equitable subordination. *Mansfield Tire*, 942 F.2d at 1062 (distinguishing tax

claims, which are not ordinarily subject to equitable subordination, from penalties, which are). In his brief, the Trustee sums up his position as follows:

> [T]he IRS's argument that equitable subordination ignores Congressional mandates for priority in reality ignores the Congressional mandate under 11 U.S.C. § 726(a) that these priorities are explicitly subject to 11 U.S.C. § 510(c). Equitable subordination of these penalties is not inconsistent with the Bankruptcy Code if the Code itself specifically authorizes it.

Here, we review the decision of the district court deciding questions of statutory interpretation *de novo*. *United States v. Hans*, 921 F.2d 81, 82 (6th Cir. 1990). It is clear that the starting point for our inquiry into the meaning of the statutes at issue is the language used by Congress. *Estate of Floyd Cowart v. Nicklos Drilling Co.*, 112 S. Ct. 2589, 2594 (1992) (citing *Demarest v. Manspeaker*, 498 U.S. 184, 190 (1991)). "[W]hen a statute speaks with clarity to an issue[,] judicial inquiry into the statute's meaning, in all but the most extraordinary circumstances, is finished." *Id.; see also United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 242 (1989) (observing that "[T]he plain meaning of legislation should be conclusive, except in 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of the drafters.'") (citation omitted). However, when there is an ambiguous term in a statute, or when a term is undefined or its meaning unclear from the context of the statute, it is our duty to examine the legislative history in order to render an interpretation that gives

effect to Congress's intent. In *re Vause*, 886 F.2d 794, 801 (6th Cir. 1989). In this case, the interpretation of the phrase "principles of equitable subordination," found in Section 510(c), is crucial to the outcome of this case and is not defined by statute. Therefore, we must look to legislative history or case law to interpret this phrase.

First, we note, as did the bankruptcy court, that the tax penalty claims here were properly characterized as postpetition administrative expenses pursuant to 11 U.S.C. § 348(d). Section 348(d) states that

> a claim against the estate or the debtor that arises after the order for relief but before conversion in a case that is converted under section 1112, 1307, or 1208 of this title, *other than a claim specified in section 503(b) of this title* [administrative expenses], shall be treated for all purposes as if such claim had arisen immediately before the date of the filing of the petition.

(emphasis added). Therefore, the tax penalty claim in this case is a *postpetition* claim—a claim against the estate of the bankrupt—and retains its priority under Section 726(a)(1).

In Chapter 7 cases, Congress gave first priority to postpetition claims for taxes and related penalty claims, as administrative expenses. However, the priority of the tax and penalty claims is specifically subject to Section 510(c) under the terms of Section 726(a). Section 726(a)(1) reads in full:

> (a) *Except as provided in section 510 of this title*, property of the estate shall be distributed—

> (1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title;

(emphasis added). Section 507(a)(1) specifies that certain claims and expenses have priority as administrative expenses. Section 507(a)(1) states:

> (a) The following expenses and claims have priority in the following order:
>
> (1) First, administrative expenses allowed under section 503(b) of this title. . . .

Section 503(b) gives the following expenses and claims first priority status as administrative expenses:

> (b) After notice and a hearing, there shall be allowed, administrative expenses . . . including—
>
> (1)(A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case;
>
> (B) any tax—
>
> (i) incurred by the estate. . . .
>
> (C) any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph;

Thus, a tax penalty relating to a tax incurred by the estate has first priority. However, Section 726(a)(1) makes the priority subject to Section 510. Subsection 510(c) permits equitable subordination and it reads:

> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
>
> > (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest;

11 U.S.C. § 510(c)(1).

Given "a normal commonsense reading" of the statutes to this point, *United States v. X-citement Video, Inc.*, 63 U.S.L.W. 4019, 4023 (U.S., Nov. 29, 1994) (Stevens, J., concurring), the language used by Congress gives tax penalty claims administrative expense priority *subject to* the bankruptcy court's equity powers. However, as Section 510(c) provides, the court's power may not be exercised arbitrarily, but only pursuant to the principles of equitable subordination. The phrase "principles of equitable subordination" is not, however, defined by the Bankruptcy Code. Thus, in order to comprehend the scope of the bankruptcy court's equitable subordination powers, we look to any relevant case law and at the legislative history to determine what Congress meant by the phrase "principles of equitable subordination."

Both the district court, and the Seventh Circuit in *Virtual Network Services*, examined in detail the legislative history of Section 510(c), as well as the meaning properly accorded that history. We agree with the Seventh Circuit's view that the statements of Representative Edwards and Senator DeConcini provide the most reliable indicia of the legislative intent as to the meaning of the phrase "principles of equitable subordination." We recite here the oft-quoted

passage from identical statements made by Representative Edwards and Senator DeConcini to their respective houses of Congress regarding Section 510(c):

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if [the] holder of such claim is guilty of inequitable conduct, *or the claim itself is of a status susceptible to subordination*, such as a *penalty*. . . .

Virtual Network Services, 902 F.2d at 1248; 11 U.S.C.A. § 510(c) note (1993) (Legislative Statements) (emphasis added); 124 Cong. Rec. H11,095 (Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. S17,412 (Oct. 6, 1978) (statement of Sen. DeConcini). What did Representative Edwards and Senator DeConcini mean by stating that a "penalty" is the type of claim susceptible to subordination? In the context of the distribution scheme of Section 726(a), perhaps they meant that penalties, other than tax penalties, are subject to the court's equitable subordination powers. Or they may have intended that only tax penalties that are punitive in nature, i.e. non-pecuniary loss penalties, be subject to equitable subordination. Despite the lack of clarity as to what Congress meant by claims that are "of a status susceptible to subordination," we must attempt to determine what claims are subject to equitable subordination. In any event, the legislative history indicates that penalty claims are susceptible to equitable subordination. Because Congress intended the "principles of equitable subordination" to follow existing case law, we turn

now to such case law as it existed in 1978 when the Bankruptcy Reform Act became effective. We will also examine further legislative history addressing what Congress may have meant when it specified a "penalty" claim as the type of claim susceptible to suborination.

At the time of the enactment of the Bankruptcy Code (Nov. 6, 1978), the case law on the principles of equitable subordination included three Supreme Court cases subordinating certain claims due to creditor misconduct and one appellate case subordinating the claims of defrauded shareholders, despite the absence of misconduct. *Comstock*, 335 U.S. 211; *Pepper*, 308 U.S. 295; *Taylor*, 306 U.S. 307; *In re Stirling Homex Corp.*, 579 F.2d 206, 211 (2d Cir. 1978) (affirming equitable subordination of the claims of allegedly defrauded stockholders to the claims of general unsecured creditors; stockholders were not guilty of misconduct), *cert. denied*, 439 U.S. 1074 (1979). The Commissioner argues that the principles of equitable subordination should not be expanded beyond cases of creditor misconduct, and certainly may not include the power to subordinate a postpetition tax penalty. To support this position, the Commissioner primarily relies on the absence of case law permitting the equitable suborination of tax penalty claims.

This absence of case law equitably subordinating tax penalty claims is explained by the fact that prior to 1978, nonpecuniary loss tax penalty claims against the estate of the bankrupt were not allowed by law. Under the Bankruptcy Act of 1898, and the ensuring reenactment of this provision in 1952, nonpecuniary loss tax penalty claims against the bankrupt's estate were simply not allowed as claims. "Debts owing to

the United States . . . as a penalty . . . shall not be allowed, except for the amount of the pecuniary loss sustained. . . ." Bankruptcy Act of 1898, ch. 541, § 57(j), 30 Stat. 561; 11 U.S.C. § 93(j), 66 Stat. 424 (1952). In 1961, the Supreme Court interpreted Section 93(j) broadly to disallow both secured and unsecured claims for tax penalties against the estate of the bankrupt. *Simonson v. Granquist*, 369 U.S. 38 (1962).

> [T]his section [57(j)/93(j)], which has been part of the Bankruptcy Act since its enactment in 1898, is in keeping with the broad aim of the Act to provide for the conservation of the estates of insolvents to the end that there may be as equitable a distribution of assets as is consistent with the type of claims involved. Moreover, *the prohibition of all tax penalties in bankruptcy* is wholly consistent with the policy of the penalty provisions themselves. Tax penalties are imposed at least in part as punitive measures against persons who have been guilty of some default or wrong. Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors.

Id. at 40-41 (emphasis added); *see also United States v. Coleman*, 344 F.2d 903, 909 (6th Cir. 1965) (noting that "[57(j)/93(j)] plainly manifests a congressional purpose to bar all claims of any kind against a bankrupt except those based on a 'pecuniary' loss").

Moreover, a few Circuits have recently developed the principles of equitable subordination to recognize the power of the bankruptcy court to subordinate a

prepetition, nonpecuniary loss tax penalty claim. The Third, Eighth, and Seventh Circuits have held that prepetition, nonpecuniary loss tax penalties are subject to equitable subordination in the appropriate case without a showing of government misconduct. *Burden* 917 F.2d at 115 (holding that prepetition, nonpecuniary loss tax penalties may be suborinated in a Chapter 13 case; bankruptcy court must balance equities; creditor misconduct not required); *Schulz Broadway Inn*, 912 F.2d at 230 (holding that equitable subordination provision applies to prepetition tax penalty claims of governmental units; misconduct not required; general unsecured creditors suffering actual losses should receive preference over Government's claim for prepetition, nonpecuniary loss penalty in liquidating Chapter 11 case); *Virtual Network Services*, 902 F.2d at 1246 (holding that bankruptcy court may equitably subordinate claim of IRS for prepetition, nonpecuniary loss tax penalties in liquidating Chapter 11 case; inequitable conduct not required). While these cases all concerned, prepetition penalties, the reasoning of these Circuits is equally applicable to postpetition penalties because the priority of both pre- and postpetition penalties is governed by 11 U.S.C. § 726(a), and this entire provision is subject to Section 510(c). Further, the legislative history of the sections we address indicates that Congress intended nonpecuniary loss tax penalties to be subject to the bankruptcy court's power to ensure that the distribution of the estate in a Chapter 7 case is equitable.

In Chapter 7 cases, Congress assigned differing priorities to pre- and postpetition penalties. 11 U.S.C. §§ 726(a)(1) and 726(a)(4). As discussed

above, Section 726(a)(1) gives administrative expense priority to *postpetition* tax penalty claims. However, unlike Section 726(a)(4), Section 726(a)(1) and its related statutes (Sections 507(a)(1) and 503(b)) do not distinguish between tax penalties that are compensatory in nature and those that are not. Section 726(a)(4), however, makes such a distinction and gives fourth priority to claims, "for any . . . penalty . . . arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such . . . penalty . . . [is] not compensation for actual pecuniary loss suffered by the holder of such claim." In other words, prepetition, as well as pre-appointment of trustee claims (whether pre- or postpetition), for nonpecuniary loss tax penalties are relegated to fourth priority. What priority Congress intended to give prepetition *pecuniary loss* tax penalty claims is unclear. Nevertheless, the language of Section 726(a)(4) indicates that in the collective mind of Congress a distinction exists between nonpecuniary loss ("punitive") penalties and pecuniary loss ("compensatory") penalties, at least so far as prepetition tax penalties are concerned.

This distinction surfaces elsewhere in the Bankruptcy Code. In Section 505, for example, the bankruptcy court is empowered to determine "the amount or legality of any tax . . . or penalty relating to tax." Prior to the approval of the final version of S. 2266, Senator DeConcini explained the House amendment to the Senate amendment to Section 505:

> The House Amendment authorizes the bankruptcy court to rule on the merits of any tax claim involving an unpaid tax, fine, or penalty relating to a tax, or any addition to a tax, of the

> debtor or the estate. This authority applies, in general, whether or not the tax, penalty, fine, or addition to tax had been previously assessed or paid. . . . The House amendment also adopts the substance of the Senate bill rule permitting the bankruptcy court to determine the amount of any penalty, *whether punitive or pecuniary in nature*, over which it has jurisdiction.

124 Cong. Rec. S17,426-27 (Oct. 6, 1978) (statement of Sen. DeConcini); 124 Cong. Rec. H11,110 (Sept. 28, 1978) (statement of Rep. Edwards) (emphasis added). The distinction between punitive and pecuniary loss tax penalties also appears in Senator DeConcini's statements regarding Section 502 [Allowance of Claims] and regarding the priority scheme in Section 507. As to Section 502, Senator DeConcini stated:

> The Senate amendment allowed this reduction [tax claim resulting from reduction in FUTA tax credit], but would have subordinated it to other claims in the distribution of the estate's assets by treating it as a *punitive (nonpecuniary loss) penalty.*

124 Cong. Rec. S17,426 (Oct. 6, 1978). The distinction between pecuniary loss and nonpecuniary loss penalties is continued in Senator DeConcini's statement regarding Section 507 (to which Section 726 (a)(1) refers). This statement implies that pecuniary loss tax penalties have first priority:

> The House amendment also adopts the provisions of the Senate amendment which include in the definition of administrative expenses under section 503 any fine, penalty (including "additions to tax" under applicable tax laws) or reduction in credit imposed on the estate. . . . For purposes of the above [Section 507] priority rules, the House amendment adopts the provision of the Senate bill that any tax liability which, under otherwise applicable tax law, is collectible in the form of a "penalty," is to be treated in the same manner as a tax liability. In bankruptcy terminology, such tax liabilities are referred to as pecuniary loss penalties. Thus, any tax liability which under the Internal Revenue Code or State or local tax law is payable as a "penalty," . . . will be entitled to the priority which the liability would receive if it were expressly labeled as a "tax" under the applicable tax law. However, *a tax penalty which is punitive in nature is given subordinated treatment under section 726(a)(4).*

124 Cong. Rec. S17,428-30 (Oct. 6, 1978) (statement of Sen. DeConcini); 124 Cong. Rec. H11,113 (Sept. 28, 1978) (statement of Rep. Edwards) (emphasis added).

The foregoing paragraph is evidence of Congress's desire to give first priority to something it calls "pecuniary loss penalties," if such things exist, and to give fourth priority to tax penalties that are truly penalties—i.e., that are punitive in nature. In light of this legislative history, including the distinction Congress has made between pecuniary loss and nonpecuniary loss tax penalties, we believe that Congress intended nonpecuniary loss, punitive penalties to be subject to the bankruptcy court's equitable subordination powers under Section 510(c). As mentioned above, both Section 726(a)(1) and 726(a)(4) are

subject to the courts' equitable subordination power under Section 510(c). This results is in accord with the Third, Seventh and Eighth Circuits' decisions interpreting the principles of equiable subordination to include the power to subordinate nonpecuniary loss tax penalties in bankruptcy cases under other chapters of the Bankruptcy Code.

In drafting Section 726(a)(1) and making it subject to Section 510(c), Congress made postpetition, nonpecuniary loss tax penalties, traditionally disallowed in bankruptcy, subject to the bankruptcy courts' equitable subordination power. A review of the sketchy legislative history of Section 510(c) reveals a statement by both of the leading legislators on this issue referring to penalties as a type of claim susceptible to subordination. The legislative history also reveals that Congress intended the courts to continue to develop the principles of equitable subordination. Therefore, we do not believe that Congress intended to arrest the development of the principles of equitable subordination as of 1978. Neither do we believe that the development of this area of law is restricted to cases of creditor misconduct. Compelling reasons of justice and equity, as well as our interpretation of the plain language of the statutes, and the legislative history regarding the purposely undefined phrase "principles of equitable subordination," move this Court to agree with the other Circuits that nonpecuniary loss tax penalty claims are one type of claim subject to equitable subordination.

The essence of bankruptcy is equity. While Congress has over the years re-codified traditional notions of equity, the current Code vests in the bankruptcy court significant discretion and equitable powers.

However, the bankruptcy court's equitable subordination powers must be exercised within the confines of the Bankruptcy Code. *In re Granger Garage, Inc.*, 921 F.2d 74, 77 (6th Cir. 1990). An examination of the Code reveals that the bankruptcy courts have the power to subordinate any claim to any other claim under the principles of equitable subordination; Congress has left the development of these principles to the courts. The wisdom of such a course is obvious, given the many ways in which parties to a bankruptcy seek advantage in recouping losses. We do not see the fairness or the justice in permitting the Commissioner's claim for tax penalties, which are not being assessed because of pecuniary losses to the Internal Revenue Service, to enjoy an equal or higher priority with claims based on the extension of value to the debtor, whether secured or not. Further, assessing tax penalties against the estate of a debtor no longer in existence serves no punitive purpose. Because of the nature of postpetition, nonpecuniary loss tax penalty claims in a Chapter 7 case, we believe such claims are susceptible to subordination. To hold otherwise would be to allow creditors who have supported the business during its attempt to reorganize to be penalized once that effort has failed and there is not enough to go around. Furthermore, to hold otherwise could result in rewarding the debtor-in-possession, the party who failed to pay the taxes on time, to the detriment of the creditors. The debtor-in-possession remains liable individually for the postpetition tax penalties. However, if the bankruptcy court cannot subordinate these penalties in the appropriate case, the creditors, and not the debtor-in-possession, will have borne the burden of paying the penalties.

Our decision today does not mean that every tax penalty assessed by the Commissioner will be equitably subordinated. Section 726(a)(1) does not require automatic subordination, and, as we have observed, there may be cases where "penalties" are not actually punitive in nature but represent compensation for some actual loss. Section 505 leaves this determination to the bankruptcy court. As with every claim for equitable subordination under Section 510(c), the bankruptcy court must weigh the equities involved. We turn, then, to whether the bankruptcy court properly subordinated the tax penalty in this case.

The bankruptcy court determined that a postpetition tax penalty claim could be equitably subordinated if the equities so required. The court went on to find that the equities balanced in favor of general unsecured creditors who suffered actual losses, as opposed to the Commissioner whose actual losses, the tax and interest claims, retained their first priority status. Because the parties agreed that the tax penalty claim was for nonpecuniary loss, the bankruptcy court did not have to decide that issue in balancing the equities of the case. Therefore, because the bankruptcy court did not clearly err in making its findings of fact, or err in its application of the law, we believe that the district court properly affirmed the decision of the bankruptcy court equitably subordinating the Commissioner's postpetition tax penalty claim to the claims of general unsecured creditors. We therefore AFFIRM the judgment of the district court.

ALICE M. BATCHELDER, Circuit Judge, concurring. I write separately only to express my view that 11 U.S.C. § 726(a) is clear and unambiguous and therefore we have no reason to speculate about the intent of particular legislators or of the Congress as to what was intended by that section. As the majority opinion points out, the Supreme Court has made it clear that we are to look to the language of the statute to determine the statute's meaning. When the statute speaks with clarity to the issue we address, our inquiry is, "in all but the most extraordinary circumstances," over. *Estate of Floyd Coward v. Nicklos Drilling Co.*, 112 S. Ct. 2589, 2594 (1991) (citation omitted), *cert. denied sub nom. Barger v. Petroleum Helicopters, Inc.*, 112 S. Ct. 3026 (1992). There are no such extraordinary circumstances present here.

Section 726(a) says that except as provided in 11 U.S.C. § 510, property of the estate is to be distributed first to pay claims of the kind and in the order specified in 11 U.S.C. § 507. Section 510 permits equitable subordination of claims. Section 507 governs priorities and gives first priority to administrative expenses allowed under § 503. Title 11 U.S.C. § 503 governs allowance of administrative expenses and allows as an administrative expense any tax incurred by the estate and any penalty relating to a tax incurred by the estate. By definition, penalties on taxes incurred by the estate are postpetition penalties. Section 503 does not set any priorities among administrative expenses; it simply identifies what those expenses are. Read together, §§ 726, 507, and 503 require that when property is distributed in a Chapter 7 proceeding, it goes first to pay administrative expenses, which include taxes incurred by the estate and penalties relating to those taxes, and that this entire

distribution scheme is subject to the equitable subordination power of the court as set out in § 510.

I have no quarrel with the majority's exploration of the legislative history behind § 510(c) in order to determine what the Congress intended by the term "principles of equitable subordination," which is nowhere defined in the statute. Noting the absence of case law equitably subordinating tax penalty claims at the time the Bankruptcy Code was adopted, the majority rightly concludes that this absence of case law is explained by the fact that before the Code was enacted, nonpecuniary loss tax penalty claims against the estate were simply not allowed at all. Further, the majority looks to subsequent case law, noting that that body of law permits equitable subordination to prepetition nonpecuniary loss tax penalty claims. So far, so good.

Having determined the meaning of "principles of equitable subordination," however, nothing requires us to delve into the legislative history of § 726. Specifically, nothing in § 726 itself permits, much less requires, a review of the legislative history of that section as part of our analysis of whether postpetition nonpecuniary loss tax penalties are subject to equitable subordination. Section 726(a) explicitly, clearly, and unambiguously makes the distribution of the property of the estate subject to the provisions of § 510. Postpetition nonpecuniary loss tax penalties are therefore subject to equitable subordination. End of story.

Because the unambiguous language of § 726 permits the equitable subordination of postpetition tax penalties, it is not necessary for us to undertake any further analysis. Indeed, it is necessary that we not do so.

APPENDIX B

[Filed Mar. 2, 1995]

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No.: 93-4311

IN RE: FIRST TRUCK LINES, INC., DEBTOR

UNITED STATES OF AMERICA, APPELLANT

v.

THOMAS R. NOLAND, Trustee, APPELLEE

Before: MARTIN, and BATCHELDER, Circuit Judges; and ENSLEN, District Judge

JUDGMENT

ON APPEAL from the United States District Court for the Southern District of Ohio at Dayton.

THIS CAUSE was heard on the record from the district court and was argued by counsel.

ON CONSIDERATION WHEREOF, it is ORDERED that the judgment of the district court is AFFIRMED.

ENTERED BY ORDER OF THE COURT

/s/ Leonard Green
LEONARD GREEN
Clerk

Issued as Mandated: March 24, 1995

APPENDIX C

[Filed Jun. 16, 1995]

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 93-4311

IN RE: FIRST TRUCK LINES, DEBTOR

UNITED STATES OF AMERICA, IRS,
PLAINTIFF-APPELLANT

v.

THOMAS R. NOLAND, TRUSTEE, DEFENDANT-APPELLEE

ORDER

Before: MARTIN, and BATCHELDER, Circuit Judges; and ENSLEN,* District Judge.

The court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this court, and no judge of this court having requested a vote on the suggestion for rehearing en banc, the petition for rehearing has been referred to the original hearing panel.

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* Hon. Richard A. Enslen, Chief Judge United States District Court for the Western District of Michigan, sitting by designation.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT

/s/ Leonard Green
LEONARD GREEN
Clerk

APPENDIX D

[Filed Sep. 21, 1993]

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF OHIO
WESTERN DIVISION

Case No. C-3-92-304

JUDGE WALTER HERBERT RICE

INTERNAL REVENUE SERVICE, APPELLANT

vs.

THOMAS R. NOLAND, TRUSTEE, APPELLEE

DECISION AND ENTRY AFFIRMING THE DECISION OF THE BANKRUPTCY COURT; JUDGMENT TO BE ENTERED IN FAVOR OF APPELLEE AND AGAINST APPELLANT; TERMINATION ENTRY

This is an appeal by the Internal Revenue Service ("IRS") from a decision by the United States Bankruptcy Court, subordinating the IRS's claim of tax penalties to the priority of the claims of general, unsecured creditors. This appeal arises out of a bankruptcy petition under Chapter 11 of the Bankruptcy Code, which First Truck Lines ("FTL") filed on April 10, 1986. After filing the petition, FTL continued its business operations as a debtor in possession. However, during its postpetition operations, FTL did not pay to the IRS the FICA and FUTA

taxes which accrued. FTL discontinued business operations, and, on August 1, 1988, the Bankruptcy Court converted the Chapter 11 proceedings to a Chapter 7 liquidation.

After this case was converted to a Chapter 7 proceeding, the Bankruptcy Court was called upon to distribute, among the various parties filing claims, the property of FTL's estate. The IRS had filed a claim for the unpaid FICA and FUTA taxes, interest on those taxes, as well as penalties on those taxes ("tax penalties").[1] The IRS further sought to have the Bankruptcy Court hold that all three components of its claim were entitled to priority as administrative expenses. The Bankruptcy Court agreed with the IRS that the three components of the IRS's claim were administrative expenses; however, pursuant to § 510(c) of the Bankruptcy Code, 11 U.S.C. § 510(c), that court held that IRS's claim for tax penalties should be equitably subordinated to the status of the claims of general unsecured creditors.[2] Thus, the IRS's claim was given priority for the unpaid taxes and for the interest on those taxes; however, its claim for tax penalties was not given such priority. The Bankruptcy Court subordinated the IRS's claim for tax *penalties* because, unlike business creditors, the IRS had not suffered an actual pecuniary loss with

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[1] The IRS filed a claim and an amended claim for taxes, interest and tax penalties, seeking the sum of $128,756.64. The trustee argued before the Bankruptcy Court that the amended claim was not a proper claim; however, that court concluded that it was a proper claim. Accordingly, that question is not before this Court, and the Court will treat the two claims (original and amended) as one.

[2] The Bankruptcy Court's decision is reported. *In re First Truck Lines, Inc.*, 141 B.R. 621 (Bkrtcy.S.D.Ohio 1992).

regard to the penalties. In other words, the IRS's claim for tax penalties, unlike those of all business creditors, did not arise atfer the surrendering of a valuable asset to the debtor.

Before this Court, the IRS presents two arguments, to wit: 1) that administrative expenses can never be equitably subordinated; and 2) that, if such expenses can be subordinated, the Bankruptcy Court improperly subordinated the tax penalties in this case. As an initial matter, the Court will set forth the familiar standard against which it must review the Bankruptcy Court's decision in this litigation. This Court reviews the Bankruptcy Court's findings of fact under a clearly erroneous standard and conducts a *de novo* review of that court's conclusions of law. *In re Caldwell*, 851 F.2d 852, 857 (6th Cir. 1988). *See also*, Bankruptcy Rule 8013.

First, the IRS argues that the tax penalties are administrative expenses and that such expenses are never subject to equitable subordination, because they are given such a high priority in § 507 of the Bankruptcy Code, 11 U.S.C. § 507. Although the tax penalties were administrative expenses,[3] this Court does not agree with the IRS that such expenses are never subject to equitable subordination. This argument presents a simple question of statutory construction. This question, like every question of statutory construction, compels this Court to determine the intent of Congress. The starting point of that analysis is,

[3] Section 507(a)(1) provides that expenses allowed under § 503(b) are administrative expenses. Section 503(b) provides that certain taxes and related penalties, including those herein, are administrative expenses. The Appellee concedes that the tax penalties are administrative penalties. *See* Doc. #6 at 2.

of course, the language of the statute. *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 241 (1989). When construing the Bankruptcy Code (and other statutes), the Supreme Court has cautioned that that inquiry must end "when the statute's language is plain." *Id.* The provision which this Court must construe is § 726(a) of the Bankruptcy Code, 11 U.S.C. § 726(a), which governs the distribution of the property in a Chapter 7 debtor's estate. Section 726(a) provides, in pertinent part:

> Except as provided in section 510 of this title, property of the estate shall be distributed—
>
> (1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title.

Section 507 is the provision by which administrative expenses are given priority. Section 510(c) of the Bankruptcy Code plainly confers upon the court the power to equitably subordinate claims.[4] Given the plain and clear language of § 726(a), it is simply not possible to conclude that administrative expenses are not subject to equitable subordination. Moreover, other courts have concluded that administrative expenses are subject to equitable subordination. For instance, in *In re Import & Mini Car Parts, Ltd., Inc.*,

[4] Section 510(c) provides, in pertinent part:

> Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
>
> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest.

136 B.R. 178, 181 (Bkrtcy.N.D.Ind. 1991), the court rejected the proposition that administrative expenses cannot be equitably subordinated, stating:

> [T]he IRS first argues that section 510(c) does not authorize the subordination of administrative expenses. Based upon the plain language of section 726(a) this argument cannot prevail. The distributive scheme established by § 726 is expressly subject to the power of subordination pursuant to § 510.

Accord In re F.A. Potts & Co., 114 B.R. 92 (Bkrtcy. E.D.Pa. 1990). Accordingly, this Court must decline the IRS's invitation to rewrite the plain language of § 726(a) and concludes that administrative expenses (in this case tax penalties) are subject to equitable subordination.

Second, having determined that administrative expenses can be equitably subordinated, the question remains as to whether the Bankruptcy Court correctly concluded that the administrative expenses (the tax penalties) in this litigation should be so subordinated. Section 510(c) does not expressly state when a claim may be equitably subordinated; rather, that section provides that claims may be subordinated "under principles of equitable subordination." The legislative history to § 510(c) explains:

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts the development of this principle. To date, under existing law, a claim is generally subordinated only if the holder of such claim is guilty of inequitable conduct, or if the claim itself is of a status susceptible to subordination, *such as a penalty* . . .

124 Cong.Rec. H11089 (Sept. 28, 1978) (statement of Rep. Edwards), *reprinted in*, 1978 USCC&AN 5787, 6452 (emphasis added); 124 Cong.Rec. S17406 (Oct. 6, 1978) (statement by Sen DeConcini), *reprinted in* 1978 USCC&AN 6505, 6521 (emphasis added).[5] Herein, there is no hint or allegation that the IRS was guilty of inequitable conduct; therefore, the only question for this Court is whether a claim for a tax penalty is of the status susceptible to subordination.

Although the Sixth Circuit has not addressed the question,[6] other circuits have consistently held that claims for tax penalties are subject to equitable subordination, even in the absence of misconduct by the government. *See, e.g., Schultz Broadway Inn v. United States*, 912 F.2d 230 (8th Cir. 1990); *Burden v. United States*, 917 F.2d 115 (3rd Cir. 1990); *Matter*

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[5] The Supreme Court has treated the statements, by Representative Edwards and Senator DeConcini, on the Bankruptcy Reform Act of 1978, as "persuasive evidence of congressional intent." *Beiger v. IRS*, 496 U.S. 53, 64 n. 5. *See also, In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055, 1058 n. 3 (6th Cir. 1991).

[6] In *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055, 1062 (6th Cir. 1991), the Sixth Circuit quoted the statement and held that the excise tax was not subject to equitable subrogation because the IRS was not guilty of inequitable conduct and the tax was not a penalty. However, the *Mansfield Tire* court did not suggest that a tax penalty is not subject to equitable subordination. Indeed, the *Mansfield Tire* court recognized that equitable subordination is appropriate "if the claim itself is of a status susceptible to subordination." *Id.*

of Virtual Network Services Corp., 902 F.2d 1246 (7th Cir. 1990). These courts have held that a court must balance the equities before subordinating a tax penalty. For instance, in *Virtual Network*, the Seventh Circuit held that the district court correctly concluded that the equities tipped in favor of subordination because it was unfair to allow the tax penalties to come from the pockets of other creditors. *Id.* at 1250. In *Schultz*, the Eighth Circuit upheld the district court's decision to equitably subordinate tax penalties and commented that the decision "accords with the legislative history of the Bankruptcy Reform Act, which generally prefers claims for actual losses over punitive claims." 912 F.2d at 234.

After weighing the equities, the Bankruptcy Court concluded that principles of equitable subordination upheld the subordination of the tax penalties in this case. This Court concludes that the Bankruptcy Court reached the proper balance. The IRS's claim for tax penalties is unquestionably a penalty,[7] an additional

[7] Before the adoption of the Bankruptcy Reform Act of 1978, tax penalties were specifically disallowed as claims against a bankrupt's estate. *Burden*, 917 F.2d at 117. In *Simmonson v. Granquist*, 369 U.S. 38, 41 (1962), the Supreme Court explained the rationale behind that disallowance:

> Tax penalties are imposed at least in part as punitive measures against persons who have been guilty of some wrong. Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors.

See also, In re Cassidy, 983 F.2d 161, 164 (10th Cir. 1992) ("The policy of protecting unsecured creditors from the bad conduct of the debtor is best implemented by avoiding burdening the claims of unsecured creditors with penalties imposed on the debtor.").

assessment, so to speak, for the debtor's having failed to pay the taxes and the interest due on the taxes in a timely manner, sums which, unlike the statutory penalties, represent actual losses (or the loss of the use of money) to the IRS. The IRS has priority to its claims for unpaid taxes and for interest on those taxes; therefore, it will not suffer a pecuniary loss if it does not obtain priority for the tax penalties. The same cannot be said for other creditors; rather, those persons provided value to FTL and will not receive that for which they bargained if the IRS is to be given priority for sums which do not represent out of pocket losses to it. Accordingly, this Court concludes that the equities tip in favor of subordinating the IRS's claim for tax penalties in this case.

Based upon the foregoing, this Court affirms the Bankruptcy Court's decision to subordinate the IRS's tax penalties to the priority of the claims of general unsecured creditors. Judgment is to be entered in favor of the Appellee and against the Appellant.

The captioned cause is hereby terminated upon the docket records of the United States District Court for the Southern District of Ohio, Western Division, at Dayton.

/s/ Walter Herbert Rice
WALTER HERBERT RICE
United States District
Judge

APPENDIX E

[Entered Jan. 25, 1992]

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF OHIO
WESTERN DIVISION

Case No. 3-86-00925
Chapter 7 (Judge Waldron)

IN RE: FIRST TRUCK LINES, INC., DEBTOR

DECISION ON ORDER ON OBJECTION

DATED AT DAYTON, OHIO this 25th day of June, 1992:

This proceeding, which arises under 28 U.S.C. § 1334(b) in a case referred to this court by the Standing Order of Reference entered in this district on July 30, 1984, is determined to be a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(B)—allowance or disallowance of claims against the estate and estimation of claims.

Presently before the court is an objection filed by the trustee to the tax claims filed by the Internal Revenue Service (Doc. 193). A hearing on this objection was held and this proceeding was taken under advisement.

BACKGROUND

The parties filed a Stipulation Of The Trustee And the United States Of America Relating To Allowance

Or Disallowance Of Claims Of the Internal Revenue Service (Doc. 216). The relevant stipulations are as follows:

1) The parties agree that this court has jurisdiction to determine the claims and requests of the Internal Revenue Service (the "IRS").

2) On April 10, 1986, the debtor voluntarily filed for relief under chapter 11 of the Bankruptcy Code.

3) The debtor moved to convert the case to chapter 7 in June, 1988. An order converting this case to chapter 7 was entered on August 1, 1988.

4) The bar date for filing claims in the chapter 7 proceeding was December 1, 1988.

5) On November 22, 1988, the IRS filed a Request for Payment of Administrative Expenses which was numbered 102 by the clerk ("Claim 102"). The amounts listed in Claim 102 involve claims which accrued postpetition and preconversion for taxes, interest, and penalties. Claim 102 did not include any claims made in previous claims or requests filed by the IRS in this case.

6) On April 20, 1989, the IRS filed a Request for Payment of Administrative Expenses which was numbered 107 by the clerk ("Claim 107").

7) On August 7, 1991, the trustee filed an objection to Claim 102 and Claim 107.

8) In response to this objection, the United States filed the United States Opposition To Trustee's Objection To Allowance Of Claims Of Internal Revenue Service (Doc. 196) and a Memorandum Of Law In Support Of The United States' Opposition To Trustee's Objection To Allowance Of Claims of Internal Revenue Service (Doc. 210). The Trustee filed a Response Of Trustee To Memorandum Of USA In

Opposition To Objection To Claim (Doc. 198) and a Memorandum Of Trustee Relative To Memorandum Of Law In Support Filed by USA For Allowance Of Claims Of The Internal Revenue Service (Doc. 211).

9) The parties agree that the tax and interest amounts in Claim 102 will be allowed as an administrative expense claim with priority under Sections 503(b), 507(a)(1), and 726(a)(1). However, the parties request that the court determine the priority, if any, of the penalties related to Claim 102.

10) The parties agree that the tax and interest claims made in Claim 107 involving quarters ending December 31, 1986 (WT-FICA) for $964.80 and December 31, 1987 (WT-FICA) for $74,670.39 are claims not raised in previous claims and should be subordinated pursuant to Section 726(a)(3). However, the parties request that the court determine the priority, if any, of the penalties related to Claim 107.

11) The parties agree that, with respect to Claim 107, the quarters ending September 30, 1986 (WT-FICA) for $264.51, September 30, 1987 (WT-FICA) for $28,039.08, March 31, 1988 (WT-FICA) for $24,363.81, June 30, 1988 (WT-FICA) for $29,718.50, the FUTA tax for the year 1987 for $3,709.46, and the corporate income tax for the year 1987 for $300.00 are the same amounts sought in previous claims timely filed in these proceedings.

12) The parties agree that, with respect to Claim 107, the amount claimed for FUTA tax for the year 1988 was greater in amount than the amount claimed in Claim 102 for the same year and that Claim 102 delineated the 1988 year as being estimated. The United States maintains that the increased amount for FUTA tax should be allowed as an administrative

expense, but the trustee maintains that the increased amount for FUTA tax should not be allowed. The parties agree that, if Claim 107 is allowed as an amended claim, the court should determine the priority, if any, of the penalties included in Claim 107.

ISSUES

Based upon the parties' stipulations, this court finds that the following issues are before this court for determination:

1) With respect to Claim 102, what priority will the tax penalties be accorded.

2) With respect to Claim 107, will a) the FUTA tax be allowed as an amendment to Claim 102 and allowed as an administrative expense, b) the penalty related to this FUTA tax be allowed as an amendment to Claim 102, and if so, what priority will it be accorded, and c) the penalties related to FICA claims, which have not been previously asserted, be allowed, and if so, what priority will these penalties be accorded.

DISCUSSION

The resolution of the interrelated issues of federal tax priorities, penalties, and subordination requires an examination of the interstices of several seemingly contradictory provisions of the Code (11 U.S.C. § 348, § 503, § 507, § 510, and § 726). The subject of an "appropriate analytical task" and an "agreed upon methodology" in statutory interpretation of the Bankruptcy Code has been continually emphasized in recent Supreme Court decisions. *Patterson v. Shumate*, No. 91-913, 1992 U.S. LEXIS 3546, 60 U.S.L.W. 4550 (U.S. June 15, 1992). This methodology may

be described by acknowledging that, although "canons of construction are no more than rules of thumb that help courts determine the meaning of legislation," *Connecticut Nat'l Bank v. Germain*, —— U.S. ——, 112 S.Ct. 1146, 1149 (1992), the initial examination commences with the language of the statute. *Pennsylvania Dept. of Public Welfare v. Davenport*, 495 U.S. 552, 110 S.Ct. 2126, 2130 (1990) ("the fundamental canon [of] statutory interpretation begins with the language of the statute itself."). "[C]ourts must presume that a legislature says in a statute what it means and means in a statute what it says there." *Germain*, 112 S.Ct. at 1149. If the statutory language is ambiguous a court must resort to examination of legislative history. *See United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 109 S.Ct. 1026, 1030 (1989). As the Supreme Court stated in *Ron Pair*, "[t]he plain meaning of legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters.'" 109 S.Ct. at 1031. "In such cases, the intention of the drafters, rather than the strict language, controls." 109 S.Ct. at 1031. Further, it is necessary to note that a court should be reluctant to "accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history." *Dewsnup v. Timm*, —— U.S. ——, 112 S.Ct. 773, 779 (1992).

I. Claim 10

The parties request that this court determine the priority to be accorded the postpetition, preconversion non-pecuniary loss tax penalties asserted in this claim. The IRS asserts that postpetition, preconversion tax penalties are administrative expenses entitled to the priority accorded by 11 U.S.C. § 507(a)(1). Section 507(a)(1) provides:

> (a) The following expenses and claims have priority in the following order:
>
> (1) First, administrative expenses allowed under section 503(b) of this title, and any fees and charges assessed against the estate under chapter 123 of title 28.

The administrative expenses allowed under § 503(b) include the taxes incurred by a bankruptcy estate. Section 503(b)(1) provides:

> (b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f), of this title, including—
>
> (1)(A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case:
>
> (B) any tax—
>
> (i) incurred by the estate, except a tax of a kind specified in section 507(a)(7) of this title; or
>
> (ii) attributable to an excessive allowance of a tentative carryback adjustment that the estate received, whether the taxable year to which such adjustment relates

> ended before or after the commencement of the case; and
>
> (C) any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph[.]

The parties have agreed that the tax and interest sought in Claim 102 will be allowed as an administrative expense under § 503(b). Because of the Code's express reference to taxes in § 503(b)(1)(B), this court determines that the parties have stipulated that the taxes will be allowed under this subsection.

As § 503(b)(1)(C) demonstrates, the penalties related to taxes which come within the provisions of § 503(b)(1)(B) are administrative expenses. Therefore, having been expressly defined as administrative expenses, the postpetition tax penalties receive first priority under § 507(a)(1).

The trustee contends, however, that these tax penalties should be subordinated. Initially, the trustee asserts that, as a result of the conversion of this case from a case under chapter 11 to a case under chapter 7, the provisions pertaining to distribution in liquidation cases, specifically § 726(a)(4), dictate the priority of the tax penalties. Section 726(a)(4) provides:

> (a) Except as provided in section 510 of this title, property of the estate shall be distributed—
>
> (4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief

> or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim[.]

At first blush it appears that there is a conflict between § 503(b)(1)(C) and § 726(a)(4), since both sections contain the same term "penalty" but do not accord it the same priority. Resolution of this conflict is found in the provisions in 11 U.S.C. § 348(d). Section 348(d), pertaining to conversion, provides:

> (d) A claim against the estate or the debtor that arises after the order for relief but before conversion in a case that is converted under section 1112, 1307, or 1208 of this title, *other than a claim specified in section 503(b) of this title*, shall be treated for all purposes as if such claim had arisen immediately before the date of the filing of the petition.

(Emphasis supplied).

Section 348(d), by expressly omitting claims under § 503(b), prevents chapter 11 administrative claims from becoming prepetition claims upon conversion. *United States v. Ginley (In re Johnson)*, 901 F.2d 513, 520 (6th Cir. 1990); *In re Bondi's Valu-King, Inc.*, 102 B.R. 108, 111 (Bankr. N.D. Ohio 1989), *aff'd*, 126 B.R. 47 (N.D. Ohio 1991); 2 *Collier On Bankruptcy* para. 348.05 at 348-10 (15th ed. 1991). Accordingly, the express statutory language indicates that these penalties retain their status as administrative claims under § 503(b)(1)(C) and are to be paid in accordance with the distribution provisions set

forth in § 726(a)(1)[1] and § 726(b),[2] and not the provisions contained in § 726(a)(4).

The trustee alternatively argues that the postpetition tax penalties sought by the IRS in Claim 102 should be equitably subordinated under 11 U.S.C. § 510(c)(1). Section 510(c)(1) provides:

> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
>
> > (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest[.]

The Bankruptcy Code does not expressly define the phrase "equitable subordination," therefore, it is

[1] (a) Except as provided in section 510 of this title, property of the estate shall be distributed—

(1) First, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title[.]

[2] Payment on claims of a kind specified in paragraph (1), (2), (3), (4), (5), (6) or (7) of section 507(a) of this title, or in paragraph (2), (3), (4), or (5) of subsection (a) of this section, shall be made pro rata among claims of the kind specified in each such particular paragraph, exceut that in a case that has been converted to this chapter under section 1112, 1208 or 1307 of this title, a claim allowed under section 503(b) of this title incurred under this chapter after such conversion has priority over a claim allowed under section 503(b) of this title incurred under any other chapter of this title or under this chapter before such conversion and over any expenses of a custodian superseded under section 543 of this title.

necessary to resort to an examination of the legislative history of the Code.[3] Legislative history indicates that the meaning of the phrase "equitable subordination" was to be developed by the courts. The Congressional Record states:

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if holder of such claim is guilty of inequitable conduct, *or the claim itself is of a status susceptible to subordination, such as a penalty* or a claim for damages arising from the purchase or sale of a security of the debtor.

124 Cong. Rec. H11089, H11095 (1978) (emphasis added) (remarks of Rep. Edwards), *printed in* 1978 U.S. Code Cong. & Admin. News 6436, 6452; *see also* 124 Cong. Rec. S17406, S17412 (1978) (remarks of Sen. DeConcini), *reprinted in* 1978 U.S. Code Cong. & Admin. News 6505, 6521. *See also United States v. Mansfield Tire & Rubber Co. (In re Mansfield Tire & Rubber Co.)*, 942 F.2d 1055, 1062 (6th Cir. 1991) ("We continue to recognize that equitable subordination in bankruptcy may be appropriate if the claimholder is guilty of inequitable conduct or if the claim itself is of a status susceptible to subordination.").

Section 510(c)(1) has been utilized to subordinate claims for non-pecuniary tax penalties. *Burden v.*

[3] As the Third Circuit noted in *Burden*, "[p]rior to the enactment of the Bankruptcy Act of 1978, subordination of tax penalty claims did not occur because noncompensatory penalty claims owed to the government were specifically disallowed. 917 F.2d at 117 (citations omitted).

United States, 917 F.2d 115 (3d Cir. 1990); *Schultz Broadway Inn v. United States*, 912 F.2d 230 (8th Cir. 1990); *In re Virtual Network Services Corp.*, 902 F.2d 1246 (7th Cir. 1990); *In re Manchester Lakes Assocs.*, 117 B.R. 221, 225 (Bankr. E.D. Va. 1990); *In re Merwede*, 84 B.R. 11, 14 (Bankr. D. Conn. 1988). These claims have been subordinated despite the absence of creditor misconduct. *Burden*, 917 F.2d at 120; *Schultz Broadway Inn*, 912 F.2d at 233; *Virtual Network Services*, 902 F.2d at 1250; *In re Merwede*, 84 B.R. at 14. The determination of whether a penalty should be subordinated requires the court to weigh the equities of the various claims on a case-by-case basis. *Burden*, 917 F.2d at 120; *Schultz Broadway Inn*, 912 F.2d at 234; *Virtual Network Services*, 902 F.2d at 1250. Otherwise, subordination would automatically occur merely because a claim is a penalty, and a major revision in the bankruptcy law such as this would warrant explicit direction from Congress. *Burden*, 917 F.2d at 119.

The IRS acknowledges that courts have subordinated tax penalties under § 510(c)(1) but contends that these decisions are not applicable to this proceeding because ethey involve prepetition tax penalties, and not postpetition tax penalties. In support of its contention the IRS distinguishes the penalties sought in this proceeding from those in *Virtual Network Services*.

In *Virtual Network Services*, the Seventh Circuit addressed the issue of whether prepetition non-pecuniary loss tax penalties could be equitably subordinated under § 510(c)(1). 902 F.2d at 1247-50. In examining the equities of the case before it, the appeals court concluded that non-pecuniary loss tax penalties could be subordinated under 11 U.S.C.

§ 510(c)(1). In reaching this determination, the appeals court examined the IRS's challenges to the district court's holding that equitable subordination would be applied to the case "because 1) the goal of equitable subordination focuses not on the conduct of the creditor but on a fairness to creditors in a particular case, 2) punishing or deterring VNS's [the debtor's] innocent creditors because of VNS's wrongful conduct serves no purpose, and 3) the IRS's claims in this case are punitive in nature." *Virtual Network Services*, 902 F.2d at 1250. Specifically, the IRS challenged the district court's holdings on grounds 2 and 3.

With respect to the district court's holding in ground 2, the IRS asserted, on appeal, that it was just as innocent as the debtor's general unsecured creditors, thus it was unfair to punish it in relation to those other creditors. In addressing this contention, the appeals court noted that the IRS had been found innocent by the district court, but that the district court also emphasized "that it [the IRS] had waited too long to collect its debt, therefore, making it unfair for the court to shift the burden of the debt to other innocent creditors." *Virtual Network Services*, 902 F.2d at 1250. With respect to its objection to ground number 3, the appeals court stated that the IRS was challenging the district court's findings that the tax penalty claims were punitive by attempting to recharacterize the nature of its claims as being unlike other non-pecuniary loss penalties because they are designed to not only punish the debtor, but to protect " 'the integrity of tax systems and to reimburse the Government for . . . costs incurred as a result of certain taxpayer misconduct.' " *Virtual Network Services*, 902 F.2d at 1250. In addressing this con-

tention, the appeals court noted that this argument had not been properly raised to the district court by the IRS; but, nonetheless, stated, "this vague assertion is an attempt to diffuse the purpose behind the tax penalties, *i.e.*, to punish those who fail to abide by the taxing structure, and to deter those who might be inclined to avoid tax payment." *Id.* The court concluded, "allowing the IRS to recover its non-pecuniary loss claims along with others who have actually 'invested' in VNS [the debtor] and lost would be unfair on these facts." *Id.* The appeals court further stated:

> As for the other grounds that the district court relied on in applying equitable subordination to the IRS's claims, we are persuaded that the district court accurately addressed the equities of this case. The district court correctly considered that it was unfair to allow the IRS's tax penalty claims to come out of the "pockets" of other general unsecured creditors who had not been paid their pecuniary losses. Moreover, in this case the debtor has sold most of its operating assets and filed an amended plan for liquidation. In other words, VNS [the debtor] exists in name only, as an entity out of which remaining funds are distributed, in this case between 15-30% of that due, to its creditors. We agree that the equities in this case favor the subordination of the IRS's claims to those of the other general unsecured creditors.

902 F.2d at 1250.

Similarly, the Eighth Circuit, in *Schultz Broadway Inn*, concluded that the IRS's tax penalty claims would be subordinated under § 510(c)(1). 912 F.2d

at 234. Notably, in *Schultz Broadway Inn*, the Government argued that subordination of non-pecuniary loss penalties is precluded under chapter 11 because Congress, as evidenced by its express subordination of non-pecuniary loss penalty claim in § 726(a)(4), intended to restrict subordination of punitive claims to proceedings under chapter 7. 912 F.2d at 233. The *Schultz Broadway Inn* court rejected the Government's argument and stated:

> [I]n proceedings under chapter 7, Congress could be certain that in most cases the debtor would cease operations with assets that were insufficient to cover the creditors' claims in full. Therefore, in the chapter 7 context, a uniform rule subordinating penalty claims recognizes that ordinary creditors should receive protection from debtors' punitive obligations.
>
> The same rule, however, would be inappropriate for proceedings under chapter 11. In chapter 11 proceedings, Congress expected that many debtors would continue their operations under a reorganization plan and ultimately return to a viable and profitable economic state. In such cases, the debtor, quite rightly, should bear the burden of its full punitive obligations. Where a chapter 11 debtor opted to liquidate, however, the consequences to creditors could be very similar to a proceeding under chapter 7.

912 F.2d at 233 (citation omitted). The *Schultz Broadway Inn* court concluded that, in accordance with the "legislative history of the Bankruptcy Reform Act, which generally prefers claims for actual losses over purely punitive claims," the "general unsecured creditors who suffered actual losses should

receive preference over the Government's claim for a non-pecuniary loss tax penalty in this liquidating chapter 11." 912 F.2d at 234. However, the court noted that, despite the preference for compensating creditors' actual losses first, appropriate circumstances may exist such that the Government's non-pecuniary loss claims will not be subordinated, but the "Government bears the burden of directly bringing such equitable considerations to the bankruptcy court's attention." *Id.*

As previously stated, in determining whether to subordinate a claim under § 510(c)(1), the various equities of the claims must be considered, The nature of the claim as arising prepetition or postpetition is only one of several factors to weigh when balancing the equities in a proceeding. In attempting to balance the equities in its favor, the IRS has made several assertions. First, the IRS asserts that it has not waited too long to collect the debt owed it when the debtor has been in bankruptcy. This court agrees. In this proceeding, unlike in *Virtual Network Services*, the IRS has not waited too long to collect its debt. Second, the IRS asserts that requiring debtors to pay penalties which are administrative expenses does not punish innocent creditors, but rather insures that chapter 11 debtors obey the law while they are under the protection of the bankruptcy court. This assertion, similar to that made by the IRS in *Virtual Network Services*, is unpersuasive in this liquidation proceeding. Penalties may punish a debtor who is attempting to reorganize and may insure that the debtor obeys the tax laws; however, in a Chapter 7 liquidation or in a liquidating chapter 11, the parties who are punished are other creditors because payment

of penalties reduces estate assets available for distribution. Third, the IRS asserts that, although the Bankruptcy Code provides for the readjustment of prepetition debts, the Code requires that administrative expenses are not to be readjusted but are to be paid in full. The IRS's assertion is correct but not complete since it ignores the equitable principles contained in § 510(c)(1). Under principles of equity, particularly when such principles are expressly contained in statutory enactments, the rigidity of otherwise applicable law is modified to comply more appropriately with legislative intention. Lastly, the IRS asserts that it would be inequitable to allow the debtor to subordinate a liability incurred by the debtor while under the protection of the bankruptcy court. Although "[t]he inclusion of penalties on postpetition taxes in section 503(b) indicates that Congress was willing to have the bankruptcy estate pay for expenses that arise out of the failure of the debtor in possession or the trustee to pay taxes in a timely manner," *United States v. Flo-Lizer, Inc.* (*In re Flo-Lizer, Inc.*), 916 F.2d 363, 366 (6th Cir. 1990), again, the provisions of § 510(c)(1) incorporate the principle of equitable subordination and, accordingly, the court must consider the equities of all claims, not just the priority of the claims of the IRS.

Weighing the foregoing against the Code's preference for compensating actual loss claims, and the fact that, in this liquidation proceeding, it appears the total amount of assets to be distributed will fully compensate only the first priority claim holders and will be distributed on a *pro rata* basis to the second priority claim holders, the court concludes that the equities tilt in favor of subordinating the postpetition

non-pecuniary loss tax penalties sought by the IRS. *See Walker v. Ferguson* (*In re Import & Mini Car Parts, Ltd., Inc.*), 136 B.R. 178, 182 (Bankr. N.D. Ind. 1991) (court analyzed the decision in *Virtual Network*, *Burden*, and *Schultz Broadway Inn* and concluded that, as a result of the equities existing in the proceedings, the postpetition tax penalties would be subordinated);[4] *In re F.A. Potts & Co., Inc.*, 114 B.R. 92, 94 (Bankr. E.D. Pa. 1990) (postpetition tax penalties assessed against debtor were subordinated under § 510(c)(1)).

II. Claim 107

This court must determine whether Claim 107, filed after the bar date, may be allowed as an amendment. Specifically, this court must determine whether the FUTA tax listed in Claim 107 may be allowed as an amendment to the FUTA tax listed in Claim 102 and as an administrative expense. Additionally, this court must determine the priority of the penalty related to the additional FUTA tax and the priority, if any, of the penalties related to the FICA claims not previously listed in any timely filed claim.

The determination of whether to permit an amendment to a timely filed proof of claim rests within the discretion of the court. *In re Wilson*, 136 B.R. 719, 721 (Bankr. S.D. Ohio 1991); *In re Parsons*, 135 B.R. 283, 284 (Bankr. S.D. Ohio 1991); *In re McLean Indus., Inc.*, 121 B.R. 704, 708 (Bankr. S.D.N.Y.

[4] However, unlike the courts in *Virtual Network Services* and *Schultz Broadway Inn*, the bankruptcy court, as the trustee requested, subordinated the tax penalties to the other unpiad chapter 11 administrative expenses. *Id.*

1990); *In re Milan Steel Fabricators, Inc.*, 113 B.R. 364, 368 (Bankr. N.D. Ohio 1990). In making this determination courts have developed a two-part test. *Parsons*, 135 B.R. at 284; *McLean*, 121 B.R. at 708; *Bishop v. United States* (*In re Leonard*), 112 B.R. 67, 71 (Bankr. D. Conn. 1990).

Under the first prong of the test, the court must determine whether the amendment reasonably relates to a timely filed claim or whether it is merely an attempt to file a new claim. *United States v. Simon* (*In re Bondi's Valu-King, Inc.*), 126 B.R. 47, 49 (N.D. Ohio 1991); *Wilson*, 136 B.R. at 721; *McLean*, 121 B.R. at 708; *Milan Steel Fabricators*, 113 B.R. at 367. ("[A]mendment to a claim is freely allowed where the purpose is to cure a defect in the claim as orignally filed, to describe the claim with greater particularity or to plead a new theory of recovery on the facts set forth in the original claim." *Milan Steel Fabricators*, 113 B.R. at 368 (quoting *United States v. Int'l Horizons, Inc.* (*In re Int'l Horizons, Inc.*), 751 F.2d 1213, 1216 (11th Cir. 1985)). Examples of amendments permitted include a correction in "the amount of tax, penalties or interest claimed in a timely filed claim." *In re Unroe*, 937 F.2d 346, 349 (7th Cir. 1991). However, if the claim is a new claim, it will be disallowed. *Milan Steel Fabricators*, 113 B.R. at 367.

Under the second prong, the court must perform an equitable analysis. *McLean*, 121 B.R. at 708; *In re Leonard*, 112 B.R. at 71. In *McLean*, the court set forth indicia to consider when balancing the equities, including:

1) whether there is undue prejudice to an opposing party,

2) whether there is bad faith or dilatory behavior on the part of the claimant,

3) whether other creditors would receive a windfall were the amendment not allowed,

4) whether other claimants might be harmed or prejudiced,

5) whether there is justification for the inability to file the amended claim at the time the original claim was filed.

121 B.R. at 708. *See also Parsons*, 135 B.R. at 285.

It is undisputed that Claim 102, the original claim, was timely filed. Claim 102 sets forth the FUTA tax owed by the debtor for two tax periods, December 31, 1987 and December 31, 1988, and states at the bottom of the claim: "Estimated tax claims have been filed because the debtor has failed to file the return(s) for the estimated periods. As soon as the debtor files the return(s) with the I.R.S. as required by law, this claim will be adjusted as necessary." The parties have agreed that the FUTA tax claims in Claim 102 will be allowed as administrative claims.

It is undisputed that the FUTA tax for the tax period December, 1987 listed in Claim 107 is identical to that in Claim 102, therefore, it is only the FUTA tax sought for the tax period December, 1988 which the IRS seeks to amend. The FUTA tax listed in Claim 107, the amended claim, is for an identical tax period as the FUTA tax listed in Claim 102. The only difference between the FUTA tax claims is the amount. Further, the FUTA tax in Claim 107, listed as an administrative claim, does not attempt to change the character or nature of the claim. Thus,

the claim for the additional FUTA tax in Claim 107 relates to the timely filed claim sought in Claim 102 and is not a new claim. For identical reasons, this court finds that the penalty related to the FUTA tax in Claim 107 relates to Claim 102, the timely filed claim. Accordingly, with respect to the FUTA tax and the penalty related to this FUTA tax, the first prong of the test has been satisfied.

With respect to the penalties which relate to FICA claims not previously listed in a timely filed claim, this court finds that these penalties do not relate to any timely filed claim. Thus, they fail to satisfy the first prong of the test utilized in determining whether to allow an amendment to a timely filed claim. Accordingly, they will be disallowed.

Having met the first prong of the test, unless equitable considerations militate strongly against this amendment, the FUTA tax will be allowed. *McLean*, 121 B.R. at 709. The trustee asserts that, if this claim is allowed, creditors in the same class will be prejudiced because it will "reduce their dividend." (Doc. 211 at 7). In light of the policy favoring liberal amendment, see *McLean*, 121 B.R. at 710, this type of prejudice by itself, in this proceeding, is insufficient. This court finds that there is no undue prejudice to the trustee or any other claimant.

Moreover, there is justification for the failure to file a timely claim.[5] The IRS stated that Claim 102 was an estimated claim. The IRS has justified the need for the statement that the tax amounts were just an estimate because "the bar date fell before the debtor's 1988 tax return was due," and no evi-

[5] This court recognizes that the IRS's amended claim was not filed until approximately 5 months following the bar date.

dence in the record exists to dispute this assertion. (Doc. 210 at 7). Although such a statement, standing alone, might not provide justification for an untimely claim, it does provide the trustee and claimants with notice that the amounts contained in the IRS's initial claim may not be accurate and may be subsequently amended.

The trustee asserts that the proposed amended claim should not be allowed because it does not state on its face that it is an "amendment." As the very party that has strenuously argued, and has thereafter benefited from the application of equitable principles on the subordination issue, it is not particularly persuasive for the trustee to attempt to prevent the application of equitable principles on the amendment issue. This court finds that Claim 107, the amended claim, though not specifically designated an "amendment," substantively constitutes an amendment and is thus determined to be an amended claim. *See In re Pyramid Building* Co., 87 B.R. 38, 40 (Bankr. N.D. Ohio 1988). "A contrary result would clearly elevate form over substance and violate equitable considerations controlling amendments." *Id.*

Further, with respect to the penalty related to the FUTA tax, this court finds no equitable considerations militating against its allowance; however, in accordance with this court's previous discussion of equitable subordination (§ 510(c)(1)), this court subordinates this penalty to that of the general unsecured creditors.

Accordingly, this court, having initially examined the plain meaning of the applicable Code provisions, and, where appropriate, having consulted legislative history and having found no evidence of congressional intention to break with the pre-Code practice of

preferring the payment of actual losses prior to the payment of penalties, and having determined that this result is not at odds with the intention of Congress, the court concludes:

1) With respect to Claim 102:

   a) the penalties are equitably subordinated to that of the general unsecured creditors,

2) With respect to Claim 107:

   a) the FUTA tax is allowed as an amendment to the FUTA tax in Claim 102 and is allowed as an administrative expense,

   b) the penalty related to this FUTA tax is allowed; however, this penalty is equitably subordinated to that of the general unsecured creditors and

   c) the penalties which relate to the FICA claims not previously listed in a timely filed claim do not amend claims in Claim 102 and are disallowed.

An order in accordance with this decision is simultaneously entered.

SO ORDERED.

/s/ Thomas F. Waldron
THOMAS F. WALDRON
United States Bankruptcy Judge

APPENDIX F

1. Section 503, 11 U.S.C. (1988), provides in relevant part:

(b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including—

(1) • • •

(B) any tax—

(i) incurred by the estate, except a tax of a kind specified in section 507 (a)(7) of this title; or

(ii) attributable to an excessive allowance of a tentative carryback adjustment that the estate received, whether the taxable year to which such adjustment relates ended before or after the commencement of the case; and

(C) any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph;

• • • • •

2. Section 507, 11 U.S.C., provides in relevant part:

(a) The following expenses and claims have priority in the following order:

(1) First, administrative expenses allowed under section 503(b) of this title, and any fees and charges assessed against the estate under chapter 123 of title 28.

• • • • •

3. Section 510, 11 U.S.C., provides in relevant part:

• • • • •

(c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—

(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or

(2) order that any lien securing such a subordinated claim be transferred to the estate.

4. Section 726, 11 U.S.C., provides in relevant part:

(a) Except as provided in section 510 of this title, property of the estate shall be distributed—

(1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title;

(2) second, in payment of any allowed unsecured claim, other than a claim of a kind specified in paragraph (1), (3), or (4) of this subsection, proof of which is—

(A) timely filed under section 501(a) of this title;

(B) timely filed under section 501(b) or 501(c) of this title; or

(C) tardily filed under section 501(a) of this title, if—

(i) the creditor that holds such claim did not have notice or actual knowledge

of the case in time for timely filing of a proof of such claim under section 501 (a) of this title; and

(ii) proof of such claim is filed in time to permit payment of such claim;

(3) third, in payment of any allowed unsecured claim proof of which is tardily filed under section 501(a) of this title, other than a claim of the kind specified in paragraph (2)(C) of this subsection;

(4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim;

(5) fifth, in payment of interest at the legal rate from the date of the filing of the petition, on any claim paid under paragraph (1), (2), (3), or (4) of this subsection; and

(6) sixth, to the debtor.

* * * * *

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No. 95-323

In The

Supreme Court of the United States

October Term, 1995

UNITED STATES OF AMERICA,

Petitioner,

vs.

THOMAS R. NOLAND, TRUSTEE FOR DEBTOR
FIRST TRUCK LINES, INC.,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

RESPONDENT'S BRIEF IN OPPOSITION

RAYMOND J. PIKNA, JR.
Counsel of Record
THOMAS R. NOLAND
ROBERT B. BERNER
GREGORY P. GARNER
ALTICK & CORWIN
1700 One Dayton Centre
One South Main Street
Dayton, Ohio 45402
(513) 223-1201

Attorneys for Respondent

7617
Lutz Appellate Services, Inc.
(800) 3 APPEAL • (800) 5 APPEAL • (800) BRIEF 21

QUESTION PRESENTED

Whether the Bankruptcy Court in a Chapter 7 case properly exercised its discretion under 11 U.S.C. § 510(c)(1) to equitably subordinate non-pecuniary loss tax penalty claims against a liquidated corporate debtor to the claims of general unsecured creditors who suffered actual pecuniary losses.

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THOMAS R. NOLAND, TRUSTEE FOR DEBTOR FIRST TRUCK LINES, INC.,

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

RESPONDENT'S BRIEF IN OPPOSITION

Respondent, Thomas R. Noland, Trustee for Debtor First Truck Lines, Inc. (the "Trustee"), respectfully requests that this Court deny the petition of the United States for a writ of certiorari (the "Petition") to review a judgment of the United States Court of Appeals for the Sixth Circuit in this case. The opinion of the court of appeals (Pet. 1a-22a) is reported at 48 F.3d 210. The opinion of the district court (Pet. 26a-33a) is not reported. The opinion of the bankruptcy court (Pet. 34a-55a) is reported at 141 Bankr. 621. This case involves matters which were correctly

decided in the lower courts and do not present "special and important reasons" which warrant granting certiorari. S. Ct. R. 10.1.

STATUTES INVOLVED

The statutes involved are 11 U.S.C. § 503(b)(1)(B) and (C), 11 U.S.C. § 507(a)(1), 11 U.S.C. § 510(c)(1), and 11 U.S.C. § 726(a). The relevant portions of these statutes are set forth in Petitioner's Appendix (Pet. 56a- 58a).

STATEMENT OF THE CASE

First Truck Lines, Inc. ("FTL") filed its Chapter 11 petition on April 10, 1986 (Pet. 2a). FTL's Chapter 11 plan was confirmed by order entered June 2, 1987 (Resp. App., *infra*, 3a). The non-pecuniary loss tax penalty claims in issue are for the tax period ending December 31, 1987 (Resp. App., *infra*, 7a) and for the post-confirmation tax quarters ended September 30, 1987, March 31, 1988, and June 30, 1988, respectively (Resp. App., *infra*, 7a). The case was converted to Chapter 7 on August 1, 1988, and Thomas R. Noland was appointed Trustee for FTL (Pet. 2a). Petitioner and the Trustee applied to the bankruptcy court for a determination of the priority, if any, to be accorded to those non-pecuniary loss tax penalty claims (Resp. App., *infra*, 11a, 12a). The bankruptcy court found that the penalty claims were administrative expenses (Pet. 40a, 53a), but held that the non-pecuniary loss tax penalty claims should be subordinated (Pet. 49a, 50a, 54a, 55a). The district court affirmed (Pet. 33a), and the Sixth Circuit Court of Appeals affirmed the decision of the district court that the bankruptcy court properly exercised its discretion to equitably subordinate the post-petition non-pecuniary loss tax penalty claims of the Internal Revenue Service ("IRS") against a liquidated corporate debtor to the actual pecuniary loss claims of general unsecured creditors (Pet. 20a).

REASONS FOR DENYING WRIT

This case does not present special and important reasons which warrant granting certiorari. There is no constitutional question, no conflict with this Court's decisions, no conflict with the decision of another United States court of appeals on the same matter, and no error in statutory interpretation or application.

1. This case does not involve any issues of constitutional law. It involves only the narrow issue of whether under 11 U.S.C. § 510(c)(1) the bankruptcy court properly exercised its discretion to equitably subordinate post-petition non-pecuniary loss tax penalty claims to the claims of general unsecured creditors who suffered actual pecuniary losses, when the assets of the debtor which the penalty was intended to punish or deter have been liquidated and the debtor has ceased operations.

2. There is no conflict with this Court's decisions. The Bankruptcy Act of 1898, as amended, contained no provision as to equitable subordination of claims analogous to 11 U.S.C. § 510(c)(1), which became effective on October 1, 1979. The decision of the court of appeals which applied 11 U.S.C. § 510(c)(1) to equitably subordinate the non-pecuniary loss tax penalty claims of the IRS against a liquidated corporate debtor to the actual pecuniary loss claims of general unsecured creditors therefore does not conflict with this Court's decisions.

3. There is no conflict with the decision of another United States court of appeals on the same matter. To the contrary, each court of appeals which has addressed the issue has concluded that equitable subordination under 11 U.S.C. § 510(c)(1) of non-pecuniary loss tax penalty claims against a liquidated corporate debtor does not require a finding of inequitable conduct. *Matter of Virtual Network Services Corp.*, 902 F.2d 1246 (7th Cir. 1990);

Schultz Broadway Inn v. United States, 912 F.2d 230 (8th Cir. 1990). By previously agreeing with those decisions, Petitioner recognized that courts continue to develop the principles of equitable subordination and admitted that cases which pre-date the enactment of the Bankruptcy Code are no longer binding.[1]

4. There is no error in the statutory interpretation or application of 11 U.S.C. § 510(c)(1). Petitioner erroneously focuses on the timing of when its claim arose rather than on the two salient factors which squarely align the decision of the court of appeals in this case with the decisions of the other two courts of appeals which have considered whether non-pecuniary loss tax penalty claims against a corporate debtor which has liquidated its assets and ceased operations may be equitably subordinated to the claims of general unsecured creditors:

a. Petitioner's claims are for non-pecuniary loss tax penalties.

b. The corporate debtor has liquidated its assets and ceased operations.

---

1. Petitioner conceded in *Burden v. United States*, 917 F.2d 115 (3rd Cir. 1990), a case involving an *individual* debtor in a Chapter 13 case and therefore having broader ramifications than the case at bar, that creditor misconduct is not a prerequisite to the equitable subordination of non-pecuniary loss tax penalty claims under 11 U.S.C. § 510(c)(1). 917 F.2d at 119. Petitioner's argument (Pet. 19-22) that there is a conflict among the decisions of courts of appeals which pre-date the enactment of the Bankruptcy Code after acknowledging the correctness of the decisions of the courts of appeals which interpret section 510(c)(1) of the Bankruptcy Code is therefore not only disingenuous, it is improper. After expressly agreeing that *Virtual Network*, *supra*, was correct and that government misconduct was not a prerequisite to the subordination of non-pecuniary loss tax penalty claims of the IRS, *Burden*, 917 F.2d at 119 n.13, Petitioner should not now be permitted to state that the courts of appeals which have adopted that position are in error and in conflict with decisions which pre-date the enactment of the Bankruptcy Code and the application of 11 U.S.C. § 510(c)(1) which is controlling in this case.

The first two courts of appeals to consider whether non-pecuniary loss tax penalty claims could be equitably subordinated to the claims of general unsecured creditors both involved corporations which had filed liquidating Chapter 11 plans. *Matter of Virtual Network Services Corp.*, 902 F.2d 1246, 1247 (7th Cir. 1990); *Schultz Broadway Inn v. United States*, 912 F.2d 230, 231 (8th Cir. 1990). It is the liquidation of the corporate debtor, *coupled with* the punitive nature of the tax penalty claims which do not compensate for actual pecuniary loss, which provides the basis for equitable subordination in appropriate cases.

"The penalty provisions in the tax code are expressly meant to deter and punish: two goals in contravention of any equity or equitable considerations." *Virtual Network*, 902 F.2d at 1249. That court recognized the inherent unfairness of allowing the IRS's non-pecuniary loss tax penalty claims to come out of the "pockets" of general unsecured creditors who had not been paid their pecuniary losses. *Id.* at 1250.

> .... In Chapter 11 proceedings, Congress expected that many debtors would continue their operations under a reorganization plan and ultimately return to a viable and profitable economic state [Citation omitted]. In such cases, the debtor, quite rightly, should bear the burden of its full punitive obligations. Where a Chapter 11 debtor opted to liquidate, however, the consequences to creditors could be very similar to a proceeding under Chapter 7.

Schultz Broadway Inn, 912 F.2d at 233.

The rationale of the *Virtual Network* and *Schultz Broadway Inn* decisions was so compelling that the IRS shortly thereafter

conceded in *Burden v. United States*, 917 F.2d 115 (3rd Cir. 1990), that subordination pursuant to 11 U.S.C. § 510(c)(1) would be proper without government misconduct[2] as long as there is a case by case determination of the relative equities of the competing claims. 917 F.2d at 119.[3] The court of appeals in this case properly followed *Virtual Network, supra*, a case with which the IRS has expressly agreed,[4] in interpreting and applying 11 U.S.C. § 510(c)(1) and concluding that the bankruptcy court properly balanced the equities in equitably subordinating Petitioner's non-pecuniary loss tax penalty claims against the liquidated corporate debtor to the claims of general unsecured creditors.

SUMMARY OF ARGUMENT

1. The post-petition non-pecuniary loss tax penalty claims of the IRS against the liquidated corporate debtor were properly subordinated in this case. The provisions of 11 U.S.C. § 510(c)(1) are expressly made applicable to all distributive provisions of 11 U.S.C. § 726, and the legislative history to

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2. This concession is consistent with congressional intent. "Congress contemplated that section 510(c)(1) would be used to subordinate claims involving *either* inequitable conduct *or* claims such as penalties that were of a 'status susceptible to subordination.'" *Schultz Broadway Inn v. United States*, 912 F.2d 230, 233 (8th Cir. 1990). No government misconduct is necessary in order to subordinate claims of a status susceptible to subordination, such as non-pecuniary loss tax penalty claims. *See* 124 Cong. Rec. H11,095 (Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. S17,412 (Oct. 6, 1978) (statement of Sen. DeConcini), *infra* at 10-11.

3. Unlike *Virtual Network, supra*, *Schultz Broadway Inn, supra*, and this case, each of which involved corporate debtors which liquidated their assets and ceased operations, *Burden* involved an individual debtor in a Chapter 13 case who might have been punished or deterred by a tax penalty claim. The court of appeals therefore reversed and remanded the case to the district court so that the equities of the various claims could be balanced. 917 F.2d at 120-21.

4. *Burden v. United States*, 917 F.2d at 119 n. 13.

section 510(c)(1) supports the application of that statutory provision to penalty claims. Because the IRS tax penalty claims do not arise from any pecuniary loss and because the tax penalty claims will not punish or deter the debtor which has liquidated all of its assets and ceased operations, equitable subordination of the non-pecuniary loss tax penalty claims of the IRS to the claims of general unsecured creditors who suffered actual pecuniary losses was proper in this case.

2. The circuit courts of appeal which have considered the issue uniformly agree that the subordination of non-pecuniary loss tax penalty claims under 11 U.S.C. § 510(c)(1) to the claims of general unsecured creditors who suffered actual pecuniary losses may be proper in certain cases involving a liquidated corporate debtor. Because the application of the principles of equitable subordination is determined on a case by case basis, the question presented does not significantly affect the administration of the bankruptcy laws and is not of substantial recurring importance.

I.

THE POST-PETITION NON-PECUNIARY LOSS TAX PENALTY CLAIMS OF THE IRS AGAINST THE LIQUIDATED CORPORATE DEBTOR WERE PROPERLY SUBORDINATED TO THE CLAIMS OF GENERAL UNSECURED CREDITORS IN THIS CASE.

A. Post-Petition Non-Pecuniary Loss Tax Penalty Claims Are Subject to the Equitable Subordination Provisions of 11 U.S.C. § 510(c)(1).

Although Petitioner states that "[t]he question presented in this case is ... not whether 'principles of equitable subordination' *may* be applied to priority claims" (Pet. 11), that is the precise issue which Petitioner seeks to address. Petitioner's

argument that "the doctrine of equitable subordination does not authorize a 'reweighing' of the balance of equities that Congress itself struck in providing the statutory priority for post-petition tax penalty claims" (Pet. 24) runs counter to Petitioner's initial focus and seeks to nullify the subordination provisions of 11 U.S.C. § 510(c)(1).

As a preliminary matter, it should be noted that chapter 5 of the Bankruptcy Code, which includes 11 U.S.C. § 510(c)(1), applies to cases under chapter 7, 11, 12, or 13 of title 11 of the United States Code. 11 U.S.C. § 103(a). The text of 11 U.S.C. § 726 leaves no doubt that the subordination provisions of 11 U.S.C. § 510 apply to the distributive provisions of Chapter 7:

> (a) Except as provided in section 510 of this title, property of the estate shall be distributed—
>
> (1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title . . . .

11 U.S.C. § 726. When the language of the Bankruptcy Code is plain, "the sole function of the courts is to enforce it according to its terms." *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 241 (1989), quoting *Caminetti v. United States*, 242 U.S. 470, 485 (1917). The fact that *all* claims, including administrative expense claims allowed under 11 U.S.C. § 503(b) which have been granted priority under 11 U.S.C. § 507(a)(1), are subject to the equitable subordination provisions of 11 U.S.C. § 510(c)(1)[5] *notwithstanding* the priority of distribution of

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5. Section 510(c)(1) of the Bankruptcy Code, 11 U.S.C. § 510(c)(1), provides in pertinent part:

> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
>
> (Cont'd)

property of the estate in Chapter 7 cases was succinctly summarized by Judge Batchelder in her concurring opinion:

> Section 726(a) explicitly, clearly, and unambiguously makes the distribution of the property of the estate subject to the provisions of § 510. Post-petition non-pecuniary loss tax penalties are therefore subject to equitable subordination. End of story.

(Pet. 22a).

There is nothing in 11 U.S.C. § 510(c)(1) which requires a finding of inequitable conduct or which freezes principles of equitable subordination in time by forever prohibiting courts of equity from making precedent even though new circumstances might warrant it. To the contrary, Congress not only contemplated that the status of a claim might be sufficient to warrant subordination, it also expressly left to the courts the development of the principles of equitable subordination.

> It is intended that the term "principles of equitable subordination" follow existing case

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(Cont'd)

> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim
>
> . . . .

Had Congress desired to exclude administrative expense claims allowed under 11 U.S.C. § 503(b) from the operation of 11 U.S.C. § 510(c), it could easily have drafted the statute as follows:

> (c) *Except as provided in section 503(b) of this title, and* notwithstanding subsections (a) and (b) of this section . . . .

> law and *leave to the courts development of this principle*. To date, under existing law, a claim is generally subordinated only if [the] holder of such claim is guilty of inequitable conduct, *or the claim itself is of a status susceptible to subordination, such as a penalty* . . . .

(Emphasis added). 124 Cong. Rec. H11,095 (Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. S17,412 (Oct. 6, 1978) (statement of Sen. DeConcini). The legislative history thus directly contradicts Petitioner's assertion that "[t]he history of Section 510(c) thus reflects that Congress consciously elected to adopt only the 'existing' principles of equitable subordination and rejected a broader equitable authority for the bankruptcy courts" (Pet. 18).[6]

Petitioner's efforts to exclude post-petition non-pecuniary loss tax penalty claims in Chapter 7 cases from the application of 11 U.S.C. § 510(c)(1) is contrary to both the text of that statute and its legislative history. The IRS's argument that equitable subordination ignores congressional mandates for priority in reality ignores the congressional mandates under 11 U.S.C. § 726(a) that these priorities are explicitly subject to 11 U.S.C. § 510(c)(1). Equitable subordination of non-pecuniary loss tax penalty claims is not inconsistent with the Bankruptcy Code if the Bankruptcy Code itself specifically authorizes it.

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6. This Court has previously determined that in the absence of a conference and in light of the key roles played by the Senate and House floor managers, Senator DeConcini and Representative Edwards, their floor statements on the Bankruptcy Code may be treated as persuasive evidence of congressional intent. *Begier v. United States*, 496 U.S. 53, 64 n. 5 (1990).

B. Subordination of Post-Petition Non-Pecuniary Loss Tax Penalty Claims Against a Liquidated Corporate Debtor to the Claims of General Unsecured Creditors Is Proper in this Chapter 7 Case.

Contrary to Petitioner's assertions (Pet. 8, 19), the court of appeals did not hold that tax penalty claims are automatically to be subordinated to all other claims, nor did the court of appeals categorically "reorder statutory priorities" (Pet. 18). The court of appeals merely held that the subordination under 11 U.S.C. § 510(c)(1) of post-petition non-pecuniary loss tax penalty claims, against a liquidated corporate debtor, to the actual pecuniary loss claims of general unsecured creditors was proper. The decision does not ensure "that claims for post-petition penalties will not be paid from the assets of bankruptcy estates" (Pet. 23) because the decision does not affect the value of the assets to be distributed; it merely affects the order of distribution. Furthermore, the decision does not allow debtors in possession "to disregard their legal obligations with impunity" (*Id.*). Those obligations remain, and the IRS may avail itself of any remedy it believes appropriate, including a motion to dismiss or convert a chapter 11 case pursuant to 11 U.S.C. § 1112(b), if a debtor in possession disregards its obligations.[7]

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7. In the present case, the IRS was lax in monitoring and enforcing taxpayer compliance by FTL. Penalties accrued during the one year period *post-confirmation* (Resp. App., *infra*, 3a, 7a) before the debtor, moved to convert the case to Chapter 7 (Pet. 2a). General unsecured creditors were not in a position to monitor FTL's failure to timely pay taxes after FTL's Chapter 11 plan was confirmed. The IRS should have monitored FTL to determine if its tax returns were timely filed and if taxes were timely paid.

If the non-pecuniary loss tax penalties are not subordinated, the IRS will be rewarded for not doing its job because the longer the IRS delays enforcing compliance, the larger the penalties, and the larger the penalties, the larger the

(Cont'd)

In considering whether to subordinate non-pecuniary loss tax penalty claims, courts must weigh the equities on a case by case basis. *Matter of Virtual Network Services Corp.*, 902 F.2d 1246, 1250 (7th Cir. 1990); *Schultz Broadway Inn v. United States*, 912 F.2d 230, 234 (8th Cir. 1990); *Burden v. United States*, 917 F.2d 115, 120 (3rd Cir. 1990). The decision of the court of appeals in this case does not affect the ability of the IRS to recover on account of its actual pecuniary loss claims for unpaid taxes and interests. (Pet. 20a). The fact that the non-pecuniary loss tax penalty claims of the IRS arose post-petition does not alter their punitive character. These penalties are meant to deter and punish, in contravention of any equity or equitable considerations. *See Virtual Network*, 902 F.2d at 1249. FTL's assets have been liquidated and FTL has ceased operations (Pet. 2a). Assessing non-pecuniary loss "tax penalties against the estate of a debtor no longer in existence serves no punitive purpose" (Pet. 19a), and will deter no conduct because no further conduct of FTL will occur.

"The goal of equitable subordination focuses not on the conduct of the creditor but on fairness to creditors in a particular case." *Virtual Network*, 902 F.2d at 1250. In this particular case, the bankruptcy court properly balanced the equities of all claims,

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(Cont'd)
IRS share of any distribution. Equitable subordination under 11 U.S.C. § 510(c)(1) is proper because the IRS could have avoided the accrual of the non-pecuniary loss tax penalty claims, and those claims should not be paid at the expense of general unsecured creditors who suffered actual pecuniary losses and were not in a position to monitor or enforce taxpayer compliance.

Not only will subordination encourage the IRS to do its job better, subordination may not affect the amount of revenues which the IRS collects from *all* sources. If the non-pecuniary loss tax penalties are subordinated, the general unsecured creditors of the debtor will receive payment which must be recognized as taxable gain by those creditors.

not just the priority of the claims of the IRS. First, the parties who are punished by the penalty claims in a Chapter 7 liquidation or in a liquidating Chapter 11 case would be other creditors rather than the defunct debtor because payment of the penalty claims would reduce estate assets available for distribution. Second, the Bankruptcy Code favors compensating actual loss claims rather than non-pecuniary loss claims. Third, the total amount of assets to be distributed in this case would fully compensate only the first priority claim holders and would be distributed on a *pro rata* basis to the second priority claim holders. Therefore, the equities tilt in favor of subordinating the post-petition non-pecuniary loss tax penalty claims of the IRS to the claims of general unsecured creditors in this Chapter 7 case (Pet. 48a - 50a).

II.

THE QUESTION PRESENTED DOES NOT SIGNIFICANTLY AFFECT THE ADMINISTRATION OF THE BANKRUPTCY LAWS AND IS NOT OF SUBSTANTIAL RECURRING IMPORTANCE.

In the sixteen years since the Bankruptcy Code became effective in 1979, this is the only case decided by a court of appeals to address the issue whether pre-conversion administrative expense non-pecuniary loss tax penalty claims against a liquidated corporate debtor may be subordinated pursuant to 11 U.S.C. § 510(c)(1) to the claims of general unsecured creditors who suffered actual pecuniary losses. The paucity of reported decisions involving identical facts demonstrates that the question presented does not significantly affect the administration of the bankruptcy laws.

Petitioner expansively refers not only to federal, state and local tax laws but also to other governmental programs in order to argue that the scope of the doctrine of equitable subordination is a

matter of substantial recurring importance. Petitioner fails to explain, however, why the scenarios it seeks to conjure up have failed to materialize. The answer is simple. The principles of equitable subordination embodied in 11 U.S.C. § 510(c)(1) are applied on a case by case basis. *Matter of Virtual Network Services Corp.*, 902 F.2d 1246, 1250 (7th Cir. 1990); *Schultz Broadway Inn v. United States*, 912 F.2d 230, 234 (8th Cir. 1990); *Burden v. United States*, 917 F.2d 115, 120 (3rd Cir. 1990); *United States v. Noland*, 48 F.3d 210, 218 (6th Cir. 1995) (Pet. 20a) ["Section 726(a)(1) does not require automatic subordination .... As with every claim for equitable subordination under Section 510(c), the bankruptcy court must weigh the equities involved."]

Congress recognized that the development of the principles of equitable subordination is best left to the courts. 124 Cong. Rec. H11,095 (Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. S17,412 (Oct. 6, 1978) (statement of Sen. DeConcini). Over time, patterns may emerge which affect the administration of the bankruptcy laws or which give rise to questions of substantial recurring importance. Such is not the case here, however. The bankruptcy court correctly found that the unique facts of this case warranted the equitable subordination under 11 U.S.C. § 510(c)(1) of the post-petition pre-conversion non-pecuniary loss tax penalty claims of the IRS against the liquidated corporate debtor to the actual pecuniary loss claims of general unsecured creditors (Pet. 55a). The question which the courts below answered does not significantly affect the administration of the bankruptcy laws and is not of substantial recurring importance.

REASONS FOR NOT REVIEWING THE CASE IN TANDEM WITH *UNITED STATES V. REORGANIZED CF&I FABRICATORS OF UTAH, INC.*

The issues presented in *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 53 F.3d 1155 (10th Cir. 1995), *petition for cert. filed*, 64 U.S.L.W. 3161 (U.S. Aug. 24, 1995) (No. 95-325), are not "closely analogous" to the issues in this case as stated in the Petition (Pet. (I)). In *Reorganized CF&I*, the primary issue is whether the pre-bankruptcy claim of the IRS under 26 U.S.C. § 4971(a) for failure to make a pension funding payment is entitled to priority under 11 U.S.C. § 507(a)(7)(E). The secondary issue is whether that general unsecured claim should be subordinated to the claims of general unsecured creditors who suffered pecuniary losses, principally the Pension Benefit Guaranty Corporation as the largest creditor. The latter issue is only peripherally related to whether non-pecuniary loss tax penalty claims against a liquidated corporate debtor should be subordinated under 11 U.S.C. § 510(c)(1) to the pecuniary loss claims of general unsecured creditors.

CONCLUSION

The Court should deny the Petition.

Respectfully submitted,

RAYMOND J. PIKNA, JR.
Counsel of Record
THOMAS R. NOLAND
ROBERT B. BERNER
GREGORY P. GARNER
ALTICK & CORWIN
1700 One Dayton Centre
One South Main Street
Dayton, Ohio 45402
(513) 223-1201

Attorneys for Respondent

APPENDIX A — COPY OF PAGE 4 OF THE BANKRUPTCY COURT DOCKET SHEET (DOCKET NO. 86-00925), ENTRIES 95 THROUGH 131

FIRST TRUCK LINES, INC. 86-00925 P4
DOCKET NUMBER

Entry	Date	Bankruptcy Proceeding Record
95	3-5-87	Order setting time for hearing on approval of proposed disclosure statement if obj are filed and if the proposed disclosure statement is approved fixing date for hearing on confirmation of plan and Applications for compensation and requiring issuance of notice (EOD 3-6-87) Hearing date 4-22-87 at 9:00 A.M.
96	3-20-87	Objection to Plan – Clark County Oil Co.
97	4-14-87	Objection to Plan – Indiana Dept. of State Revenue's.
98	4-15-87	Objection to confirmation of amended plan. IRS
99	4-22-87	Hearing on Objection to Disclosure Statement Held. *Amended Disclosure Statement to be filed.*
100	4-23-87	Financial statement for 1-31-87.
101	4-23-87	Financial statement for 2-28, 1987.

Appendix A

Entry	Date	Bankruptcy Proceeding Record
102	4-24-87	Plan of reorganization as modified. (PL #4)
103	4-27-87	Order approving disclosure statement as modified.
104	4-27-87	Modified disclosure statement approved as containing adequate information.
105	5-5-87	Certificate of mailing modified Disclosure Statement.
106	5-7-87	Supplemental application of counsel for compensation.
107	5-7-87	Notice of applications of counsel for debtor for compensation.
108	5-26-87	Report of ballots on plan of reorganization.
109	5-26-87	Financial statement for March 31, 1987.
110	5-26-87	Financial statement for April 30, 1987.
111	5-27-87	HEARING HELD. MR. DONAHUE TO SUBMIT CONFIRMATION ORDER WITHIN ONE WEEK. ATTY. FEES APPROVED. MR. DONAHUE TO SUBMIT ORDER RE: ATTORNEY FEES WITHIN ONE WEEK.

Appendix A

Entry	Date	Bankruptcy Proceeding Record
112	6-2-87	Order confirming plan of reorganization as modified.
113	6-2-87	Order for post Confirmation reports.
114	6-2-87	Order for final report & application for final decree.
115	6-10-87	Order allowing compensation.
116	6-25-87	Financial statement for may, 1987
117	6-25-87	Cert. of service.
118	7-19-87	Financial Report for 6 month period ending 6-30-87
119	8-19-87	Debtor's objection to claim of T.W. Inman, Inc.
120	8-19-87	Debtor's objection to claim of L.H. Smith Oil Corp.
121	8-20-87	Amendment to schedule A-3
122	8-20-87	Application for order approving & allowing claims & Admins. expenses.
123	8-25-87	Order approving and allowing claims & Administrative expenses.

Appendix A

Entry	Date	Bankruptcy Proceeding Record
124	8-26-87	ORDER FOR HEARING 9-25-87 11:00 A.M.
125	8-26-87	Computer Notice re: Amendment to Schedules filed 8-20-87
126	9-17-87	Notice of filing of exhibit and witness list.
127	9-17-87	Witness list A.
128	9-18-87	Debtor's response to order directing filing of certain documents.
129	9-25-87	HEARING NOT HELD, AGREED ORDER TO BE SUBMITTED BY MIKE CRAMAROSSO WITHIN ONE WEEK.
130	9-28-87	Financial statement for the period ending July, 1987.
131	9-30-87	Stipulation and agreement for allowance of claim of L.H. Smith Oil Corp.

APPENDIX B — REQUEST FOR PAYMENT OF INTERNAL REVENUE TAXES (PROOF OF CLAIM #102) FILED NOVEMBER 22, 1988

REQUEST FOR PAYMENT OF INTERNAL REVENUE TAXES

(Bankruptcy Code Cases — Administrative Expenses)

Department of the Treasury/Internal Revenue Service

United States Bankruptcy Court for the Southern District of OH

In the Matter of:

FIRST TRUCK LINES, INC
1500 FARR DR
DAYTON OH 45404

Fiduciary:

Case Number
38600925

Type of Bankruptcy Case
Chap. 7

Date of Petition
04/10/86

Taxpayer Identifying Number
Social Security Number
Employer identification Number
illegible

Appendix B

1. The undersigned, whose business address is *P.O. Box 1579, CINCINNATI, OH 45201,* is the agent of the Department of Treasury, Internal Revenue Service, and is authorized to make this request for payment on behalf of the United States.

2. Request is made for payment of taxes and any interest or penalty due under the internal revenue laws of the United States, as shown below.

3. The ground of liability is taxes due under the internal revenue laws of the United States.

Appendix B

Administrative Claims

Kind of Tax	*Tax Period*	*Tax Due*	*Accrued Interest as of 10 Days from the Date of this Request*	*Accrued Penalty as of 10 Days from the Date of this Request*	*Balance Due*
FUTA	12/31/87	3,055.66	478.62	175.18	3,709.46
FUTA	12/31/88	1,750.00	.00	.00	1,750.00
WT-FICA	09/30/87	16,423.86	3,029.20	8,586.02	28,039.08
WT-FICA	03/31/88	21,075.52	2,698.49	589.80	24,363.81
WT-FICA	06/30/88	24,862.92	4,848.18	7.40	29,718.50
CORP-INC	12/31/87	300.00	.00	.00	300.00

Appendix B

*** ESTIMATED TAX CLAIMS HAVE BEEN FILED BECAUSE THE DEBTOR HAS FAILED TO FILE THE RETURN(S) FOR THE ESTIMATED PERIODS. AS SOON AS THE DEBTOR FILES THE RETURN(S) WITH THE I.R.S. AS REQUIRED BY LAW, THIS CLAIM WILL BE ADJUSTED AS NECESSARY.**

Amount due as of 10 days from date of this request $87,880.85

Compound interest will accrue at the rate established under IRC Section 6621(b). Contact Chief, Special Procedures function at *see below* for balance due if paid after *11/28/88*. Dollar amount per month at which late payment penalty will be charged (at 1/2 of 1 percent a month) after 10 days from the date of this request $67,467.96

Penalty for Presenting Fraudulent Claim — Fine of not more than $5,000 or Imprisonment for not more than 5 years or both — Title 18, U.S.C., Section 152.

Signature
s/ Marilyn J. Hicks

Title
Manager, Procedures & Insolvency Unit

Date
11/18/88

Telephone Number
(513) 684-2442

APPENDIX C — STIPULATION OF THE TRUSTEE AND THE UNITED STATES OF AMERICA RELATING TO ALLOWANCE OR DISALLOWANCE OF CLAIMS OF THE INTERNAL REVENUE SERVICE

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF OHIO
WESTERN DIVISION

Case No. 3-86-00925

Chapter 7

Judge Thomas F. Waldron

IN RE:

FIRST TRUCK LINES, INC.,

Debtor.

STIPULATION OF THE TRUSTEE AND THE UNITED STATES OF AMERICA RELATING TO ALLOWANCE OR DISALLOWANCE OF CLAIMS OF THE INTERNAL REVENUE SERVICE

The United States of America and the Trustee have agreed to certain facts that are stipulated to for the purposes of the hearing regarding the allowance or disallowance of the claims of the Internal Revenue Service set for February 7, 1992 at 10:30 A.M. The stipulated facts are as follows:

1. The Debtor filed for Chapter 11 relief on April 10, 1986.

2. On July 1, 1986, the Internal Revenue Service ("IRS")

filed its Proof of Claim, which was dated June 30, 1986, and which was marked number 51 by the Clerk (Exhibit A).

3. On February 20, 1987, the IRS filed a Request for Payment of Administrative Expenses, which was numbered 75 by the Clerk (Exhibit B).

4. On July 13, 1987, the IRS filed its Proof of Claim, which was numbered 85 by the Clerk, and which stated that it was "Amendment #1 to the proof of claim dated 6-30-86" (Exhibit C).

5. The Debtor moved to convert the proceedings to Chapter 7 in June, 1988 and an order converting the proceedings to Chapter 7 was entered on August 1, 1988.

6. The bar date for filing claims in the Chapter 7 proceeding was December 1, 1988.

7. On November 22, 1988, the IRS filed a Request for Payment of Administrative Expenses which was numbered 102 by the Clerk. The amounts claimed in said proof of claim involved claims accruing post-petition and pre-conversion, for taxes, interest and penalties. This Request for Payment did not involve any claims made in previous claims or requests filed by the IRS in this case (Exhibit D).

8. On April 20, 1989, the IRS filed a Request for Payment of Administrative Expenses which was numbered 107 by the Clerk (Exhibit E).

9. On August 7, 1991, the Trustee filed his Objection to the Proofs of Claim and the Requests for Payment.

10. The United States filed its opposition to the Trustee's objection on August 31, 1991, and the Trustee filed his response on September 13, 1991.

11. The parties agree that this Court has jurisdiction to determine the claims and requests of the IRS.

12. The parties agree that claim number 85 should be allowed, except for the amount of $13,415.20 for estimated claims relating to Highway Use taxes for the period of July 31, 1984. The parties agree that the penalties contained in claim number 85, which were pre-petition penalties, are subordinated pursuant to Section 726(a)(4) of the Code. The remaining liabilities set forth in claim number 85 will be allowed as a Section 507(a)(7) priority claim.

13. The parties agree that the tax and interest amounts of the Request for Payment number 102 will be allowed as an administrative expense claim with priority under Sections 503(b), 507(a)(1) and 726(a)(1). The parties agree that the Court should determine the priority, if any, of the penalties related to Request for Payment number 102.

14. The parties agree that the tax and interest claims made in Request for Payment number 107 involving quarters ending December 31, 1986 (WT-FICA) for $964.80 and December 31, 1987 (WT-FICA) for $74,670.39, are claims not raised in previous claims and should be subordinated pursuant to Section 726(a)(3). The parties agree that the Court should determine the priority, if any, of the penalties related to Request for Payment number 107.

15. The parties agree that as to Request for Payment number

107, the quarters ending September 30, 1986 (WT-FICA) for $264.51, September 30, 1987 (WT-FICA) for $28,039.08, March 31, 1988 (WT-FICA) for $24,363.81, June 30, 1988 (WT-FICA) for $29,718.50, and the FUTA tax for the year 1987 for $3,709.46, and Corporate Income Tax for the year 1987 for $300.00, were the same amounts claimed in previous claims timely filed in these proceedings.

16. The parties agree as to Request for Payment number 107 that the amount claimed for FUTA taxes for the year 1988 was greater in amount than the amount claimed in Request for Payment number 102 for the same year, and that Request for Payment number 102 delineated the 1988 year as being estimated. The Trustee maintains that the increased amount for FUTA taxes should not be allowed, and the United States maintains that the increased amount for FUTA taxes should be allowed as an administrative expense. The parties agree that if Request for Payment number 107 is allowed as an amended claim, that the Court should determine the priority, if any, of the penalties included in Request for Payment 107.

s/ Pamela M. Stanek
Pamela M. Stanek-0030155
Assistant U.S. Attorney
602 Federal Building
200 W. Second Street
Dayton, Ohio 45402
(513) 225-2910

s/ Thomas R. Noland
Thomas R. Noland-0018239
Attorney for Trustee
900 Talbott Tower
Dayton, Ohio 45402
(513) 223-1201

Supreme Court, U.S.
FILED
NOV 7 1995
CLERK

(3)

No. 95-323

In the Supreme Court of the United States

OCTOBER TERM, 1995

UNITED STATES OF AMERICA, PETITIONER

v.

THOMAS R. NOLAND, TRUSTEE FOR DEBTOR
FIRST TRUCK LINES, INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

DREW S. DAYS, III
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 514-2217

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REPLY BRIEF FOR THE UNITED STATES

---

1. In this case, the court of appeals applied judge-made "principles of equitable subordination" to nullify the determination of Congress that postpetition tax penalties should be given "[f]irst" priority in the distribution of the assets of the debtor's estate (11 U.S.C. 507(a)(1)). The court predicated its decision on the view that payment of the tax penalty claim on a first priority basis would be "unfair" to creditors who had extended value to the debtor because it would reduce the assets available for distribution to them (Pet. App. 19a). By allowing its views of what is "fair"

or "unfair" to override the express congressional determination as to the priority to be afforded to these competing claims, the court of appeals violated the fundamental principle that a bankruptcy court's equitable powers "must and can only be exercised within the confines of the Bankruptcy Code" (*Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 206 (1988)). The Sixth Circuit's decision also conflicts with the established rule that equitable subordination in bankruptcy does *not* permit a court "to contradict statutory or common law when [it] feels a fairer result may be obtained by application of a different rule." *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d 784, 787 (9th Cir.), cert. denied, 423 U.S. 913 (1975). The court further compounded its error by ignoring the decisions of this Court that hold that claims for postpetition penalties are to be paid from the assets of the estate in order to ensure compliance with the laws that the penalties are designed to enforce. See *Nicholas* v. *United States*, 384 U.S. 678, 694 (1966); *Boteler* v. *Ingels*, 308 U.S. 57, 61 (1939).[1]

2. Respondent errs in contending (Br. in Opp. 11) that the decision in this case will not result in the nonpayment of postpetition tax penalty claims in bankruptcy cases. The court of appeals subordinated the government's claim precisely *because* the estate lacked sufficient assets to satisfy the claims of all creditors (Pet. App. 19a). It is obvious that a similar deficiency in assets exists in virtually all bankruptcy cases. Moreover, in the rare case in which a bankruptcy estate has sufficient assets to satisfy all

[1] Respondent does not dispute that the court of appeals erred in stating (Pet. App. 12a-13a) that all penalty claims were disallowed under the former Bankruptcy Act.

claims, there would be no need to invoke the doctrine of equitable subordination—for all claims would then be paid.

The priority scheme of the Bankruptcy Code serves a purpose only when the assets of the bankruptcy estate are not sufficient to satisfy all claims. The approach adopted by the court of appeals in this case deviates from the priority scheme that Congress enacted by nullifying the express award of first priority to postpetition tax penalties under Section 507(a)(1) of the Bankruptcy Code.[2]

3. Respondent errs in contending (Br. in Opp. 8-9) that the "plain language" of Section 726 supports the decision of the court of appeals. Section 726 merely provides that the priorities Congress established in the Bankruptcy Code apply in Chapter 7 cases "[e]xcept as provided in section 510" (11 U.S.C. 726(a)). Section 726 does not provide any guidance on the issue that is critical to this case: which is *how* the

[2] Respondent argues (Br. in Opp. 11 n.7) that equitable subordination is appropriate to punish the IRS for failure to monitor the estate's compliance with the tax laws. That contention is in error for several reasons. First, the statutory grant of first priority is not contingent upon IRS monitoring of the debtor. Second, as this Court recognized in *Nicholas* v. *United States*, 384 U.S. at 694, the grant of first priority is made precisely to ensure that trustees and debtors-in-possession comply with the tax laws. To argue, as respondent does, that penalty claims should not be paid because the debtor-in-possession did not comply with its obligations turns the statute on its head. Moreover, it is unrealistic to suggest that the IRS is in a position to monitor the internal practices of thousands of bankruptcy estates. Ours is a self-reporting system of taxation, which relies on penalties to assure compliance.

"principles of equitable subordination" codified in Section 510(c) are to be applied.[3]

The decisions of this Court and of other courts of appeals establish that "principles of equitable subordination" require the presence of creditor misconduct. See *Comstock* v. *Group of Institutional Investors*, 335 U.S. 211, 229 (1948) ("It is not mere existence of an opportunity to do wrong that brings the rule into play; it is the unconscionable use of the opportunity afforded by the domination to advantage itself at the injury of the subsidiary that deprives the wrongdoer of the fruits of his wrong."); *In re Columbia Ribbon Co.*, 117 F.2d 999, 1002 (3d Cir. 1941); *Benjamin* v. *Diamond*, 563 F.2d 692, 700 (5th Cir. 1977) (equitable subordination requires that "[t]he claimant must have engaged in some type of inequitable conduct"); *United States* v. *Killoren*, 119 F.2d 364, 366 (8th Cir.), cert. denied, 314 U.S. 640 (1941); *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 787. Moreover, as the petition notes (Pet. 17-19), in codifying these preexisting "principles of equitable subordination" in Section 510(c) of the Bankruptcy Code, Congress considered and rejected a provision that would have granted bankruptcy courts

[3] Respondent errs in asserting (Br. in Opp. 7-8) that the issue in this case is whether equitable subordination applies to priority claims. We do not dispute that priority claims in Chapter 7 cases *may* be subordinated. The question presented by this case involves the *circumstances* under which subordination may be accomplished under "principles of equitable subordination." In our view, those circumstances require creditor misconduct; any subordination based simply upon *the nature of the claim itself* necessarily undertakes to reweigh the competing equities that Congress itself balanced in formulating the statutory priority scheme.

authority to subordinate claims on the broader grounds asserted by the court of appeals in this case.

4. Respondent does not cite or discuss the decisions of the courts of appeals under the former Bankruptcy Act that established the "principles of equitable subordination" that Congress codified in Section 510(c) of the Bankruptcy Code. See, *e.g.*, *In re Columbia Ribbon Co.*, 117 F.2d at 1002; *United States* v. *Killoren*, 119 F.2d at 366; *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 787. Moreover, respondent does not dispute that the decision of the court of appeals in the present case conflicts with those preexisting decisions. And, except for the fact that Congress codified the preexisting "principles of equitable subordination" in Section 510(c) of the Code, respondent offers no basis for distinguishing those decisions from the conflicting decision in the present case. In sum, respondent's contention that a conflict does not exist rests solely upon the untenable proposition that Congress changed the preexisting "principles of equitable subordination" under the guise of codifying them.

5. Contrary to respondent's contention (Br. in Opp. 13-14), the decision in the present case has exceptional administrative importance. Trustees and debtors-in-possession often incur tax penalties during the administration of a bankruptcy estate. In *Nicholas* v. *United States*, 384 U.S. at 699, this Court emphasized the importance of requiring payment of such penalties on a first priority basis, to ensure that debtors and trustees abide by the same rules of law that apply to other businesses. As the petition notes (Pet. 22-23), the decision in this case has recurring importance not only for enforcement of federal, state and local tax laws; it also threatens to undermine

enforcement of a broad variety of governmental regulations, such as health and safety rules that are designed to protect workers and the public at large.

Moreover, as one commentator has noted, by unhinging the doctrine of equitable subordination from its traditional framework, the rationale applied by the court of appeals in this case affects not only governmental claims; it has also sent a "chill" through the financial community by threatening to "eclipse the structure of bankruptcy prioritization." Note, *No Fault Equitable Subordination: Reassuring Investors That Only Government Penalty Claims Are At Risk*, 34 Wm. & Mary L. Rev. 487, 488 (1993). By ignoring and nullifying the priorities that Congress established, the reasoning applied by the court of appeals in this case poses a serious threat to the integrity of the statutory scheme that Congress enacted.

6. As noted in the petition (Pet. 10 n.1), we suggest that this case be set for argument together with *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, No. 95-325, in the event that certiorari is granted in both cases. The second question presented in the *CF&I* case is whether a prepetition excise tax claim under Section 4971(a) of the Internal Revenue Code, 26 U.S.C. 4971(a), may be equitably subordinated to general unsecured claims in the absence of creditor misconduct. Although respondent suggests (Br. in Opp. 15) that the *CF&I* case is distinguishable, the controlling question presented in both cases is identical: whether Section 510(c) of the Bankruptcy Code authorizes equitable subordination of claims in the absence of creditor misconduct. The Tenth Circuit recognized the closeness of these two cases by

relying on the Sixth Circuit's decision in this case in its opinion in *CF&I*. See 53 F.3d 1155, 1158 (1995).

* * * * *

For the reasons set forth above and in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

DREW S. DAYS, III
Solicitor General

NOVEMBER 1995

Supreme Court, U.S.
FILED
JAN 16 1996
CLERK

No. 95-323

In the Supreme Court of the United States

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v.

THOMAS R. NOLAND, TRUSTEE FOR DEBTOR
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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES

DREW S. DAYS, III
Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

KENT L. JONES
Assistant to the Solicitor General

GARY D. GRAY
EDWARD T. PERELMUTER
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 514-2217

QUESTION PRESENTED

Taxes and tax penalties that arise after the date of a bankruptcy filing are "administrative expenses" of the bankruptcy estate. 11 U.S.C. 503(b)(1)(B) and (C). As "administrative expenses," such taxes and tax penalties are entitled to first priority in the distribution of the estate. 11 U.S.C. 507(a)(1). This case presents the following question:

Whether the statutory priority that Congress conferred on the government's claim for postpetition tax penalties may—under the "principles of equitable subordination" codified in Section 510(c)(1) of the Bankruptcy Code, 11 U.S.C. 510(c)(1)—be subordinated to the claims of general unsecured creditors solely because a court determines that it would enhance "fairness" and "justice" to pay the general creditors first.

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In the Supreme Court of the United States

OCTOBER TERM, 1995

No. 95-323

UNITED STATES OF AMERICA, PETITIONER

v.

THOMAS R. NOLAND, TRUSTEE FOR DEBTOR FIRST TRUCK LINES, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-20a) is reported at 48 F.3d 210. The opinion of the district court (Pet. App. 26a-33a) is unreported. The opinion of the bankruptcy court (Pet. App. 34a-55a) is reported at 141 B.R. 621.

JURISDICTION

The judgment of the court of appeals (Pet. App. 23a) was entered on March 2, 1995. A petition for rehearing was denied on June 16, 1995 (Pet. App. 24a). The petition for a writ of certiorari was filed on August 25, 1995, and was granted on December 1,

1995. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

Sections 503(b)(1)(B) and (C), 507(a)(1), 510(c) and 726(a) of the Bankruptcy Code, 11 U.S.C. 503(b)(1)(B) and (C), 507(a)(1), 510(c) and 726(a), are reproduced at Pet. App. 56a-58a.

STATEMENT

1. In 1986, First Truck Lines, Inc., filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code and continued to operate its business as debtor-in-possession. During the following two years, the debtor failed to pay the social security and unemployment taxes accruing from its operations. After efforts to reorganize the debtor proved unsuccessful, the bankruptcy case was converted to a Chapter 7 liquidation in 1988. Respondent was appointed trustee at that time (Pet. App. 2a).

The Internal Revenue Service filed a request for payment of the taxes, interest and tax penalties that accrued after the filing of the bankruptcy petition. Respondent stipulated that, under Section 503(b)(1)(B) of the Bankruptcy Code, 11 U.S.C. 503(b)(1)(B), the unpaid postpetition taxes and interest are "administrative expenses" that are entitled to first priority in distribution of the assets of the estate under Section 507(a)(1) of the Code, 11 U.S.C. 507(a)(1). Respondent asserted, however, that postpetition tax penalties are not entitled to priority in distribution. The parties applied to the bankruptcy court for resolution of that dispute (Pet. App. 2a-3a).

2. The bankruptcy court acknowledged (Pet. App. 40a) that Section 503(b)(1)(C) of the Bankruptcy Code

expressly defines postpetition tax penalties to be "administrative expenses" (11 U.S.C. 507(a)(1)). The court observed, however, that Section 510(c)(1) of the Bankruptcy Code, 11 U.S.C. 510(c)(1), provides that a court may (*ibid.*),

> under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim * * *.

Because Section 510(c)(1) "does not expressly define the phrase 'equitable subordination,'" the court stated that it would "resort to an examination of the legislative history" (Pet. App. 42a-43a).

At the time the Bankruptcy Code was enacted in 1978, the floor statement of the House sponsor stated (Pet. App. 43a, quoting 124 Cong. Rec. 32,398 (1978) (Rep. Edwards), and citing 124 Cong. Rec. 33,998 (1978) (Sen. DeConcini) (emphasis added by court)):

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if [the] holder of such claim is guilty of inequitable conduct, *or the claim is of a status susceptible to subordination, such as a penalty* or a claim for damages arising from the purchase or sale of a security of the debtor.

The bankruptcy court concluded that this legislative history evidences that Congress intended that a tax "penalty"—like any other "penalty"—would be "susceptible to subordination" under the "principles of equitable subordination" codified in Section 510(c) of the Code (Pet. App. 43a). The court deemed it

irrelevant that in 1978 Congress provided a specific statutory priority for postpetition tax "penalties" (11 U.S.C. 503(b)(1)(C)). The court also found it irrelevant that the United States had not been "guilty of inequitable conduct" in asserting its claim. The court concluded that the government's claim for tax penalties is subject to equitable subordination simply because it is designed to enforce a "penalty" (Pet. App. 44a).

In applying the "principles of equitable subordination" codified in Section 510(c)(1) of the Bankruptcy Code, the court stated that its task is to "weigh the equities of the various claims on a case-by-case basis" to determine whether subordination is appropriate (Pet. App. 44a). The court began its "weighing" or "balancing" of "the equities" by distinguishing between the pecuniary losses incurred by general commercial creditors and the nonpecuniary loss represented by statutory tax penalties. Finding that the Bankruptcy Code contains a "preference for compensating actual loss claims," the court held "that the equities tilt in favor of subordinating the postpetition non-pecuniary loss tax penalties sought by the IRS" to the claims of general unsecured creditors of the debtor (*id.* at 49a-50a). Otherwise, the court noted, the assets available for payment of the general unsecured creditors would be reduced by the amount of the tax penalties that, by statute, were given first priority in distribution as administrative expenses of the estate (*ibid.*).

3. The district court affirmed (Pet. App. 26a-33a). The court stated that all types of priority claims—including first priority claims for administrative expenses—may be subordinated under the "principles of equitable subordination" that Congress codified in

Section 510(c) of the Bankruptcy Code (Pet. App. 29a). The court agreed with the bankruptcy court that the "principles of equitable subordination" are not restricted to remedying inequitable misconduct by creditors. The court held, instead, that the "principles of equitable subordination" permit a tax "penalty" to be subordinated solely in order to promote the claims of other creditors who suffered pecuniary losses from their dealings with the estate (*id.* at 32a-33a).

The district court emphasized that "other creditors * * * provided value to [the debtor] and will not receive that for which they bargained if the IRS is to be given priority for sums which do not represent out of pocket losses to it" (Pet. App. 33a). For this reason, the court concluded that "the equities tip in favor of subordinating the IRS's claim for tax penalties in this case" (*ibid.*).

4. a. The court of appeals affirmed (Pet. App. 1a-20a). The court noted that this Court has applied "principles of equitable subordination" in bankruptcy cases only in situations involving "creditor misconduct" (*id.* at 5a, citing *Comstock* v. *Group of Institutional Investors*, 335 U.S. 211 (1948); *Pepper* v. *Litton*, 308 U.S. 295 (1939); *Taylor* v. *Standard Gas & Electric Co.*, 306 U.S. 307 (1939)). The court also noted that, in *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055 (1991), cert. denied, 502 U.S. 1092 (1992), another panel of that circuit held that the government's claim for prepetition excise tax liabilities—which have *seventh* priority in distribution under Section 507(a)(7) of the Bankruptcy Code—is *not* subject to equitable subordination solely in order to improve the "fairness" of the distribution to other creditors (Pet. App. 5a-6a). The court held, however,

that none of those decisions is controlling in the context of this case, which concerns the application of "principles of equitable subordination" to a tax "penalty" (*id.* at 6a).

The court of appeals followed the analysis of the bankruptcy court in concluding that the legislative history of Section 510(c) indicates that a statutory "penalty" is properly subject to equitable subordination. The court noted that the floor statement of the House sponsor of the 1978 Bankruptcy Reform Act reflected that Congress intended to "follow existing case law and leave to the courts development of this principle" (Pet. App. 11a, quoting 124 Cong. Rec. 32,398 (1978) (Rep. Edwards)). The court acknowledged that there was no "existing case law" as of 1978 that supported the equitable subordination of tax penalty claims. The court ascribed this, however, to the fact that, "prior to 1978, nonpecuniary loss tax penalty claims against the estate of the bankrupt were not allowed by law" (Pet. App. 12a). The court noted that three more recent decisions have held that claims for *pre*petition, *non*priority tax penalties may be equitably subordinated even though no governmental misconduct occurred (*id.* at 14a, citing *Burden* v. *United States*, 917 F.2d 115, 119-120 (3d Cir. 1990); *In re Virtual Network Services Corp.*, 902 F.2d 1246, 1248-1250 (7th Cir. 1990); and *Schultz Broadway Inn* v. *United States*, 912 F.2d 230, 232-234 (8th Cir. 1990)). The court stated that the reasoning of those decisions applied directly to this case (Pet. App. 19a):

> We do not see the fairness or the justice in permitting the Commissioner's claim for tax penalties, which are not being assessed because of

> pecuniary losses to the Internal Revenue Service, to enjoy an equal or higher priority with claims based on the extension of value to the debtor, whether secured or not. Further, assessing tax penalties against the estate of a debtor no longer in existence serves no punitive purpose. Because of the nature of postpetition, nonpecuniary loss tax penalty claims in a Chapter 7 case, we believe such claims are susceptible to subordination. To hold otherwise would be to allow creditors who have supported the business during its attempt to reorganize to be penalized once that effort has failed and there is not enough to go around. Furthermore, to hold otherwise could result in rewarding the debtor-in-possession, the party who failed to pay the taxes on time, to the detriment of the creditors. The debtor-in-possession remains liable individually for the postpetition tax penalties. However, if the bankruptcy court cannot subordinate these penalties in the appropriate case, the creditors, and not the debtor-in-possession, will have borne the burden of paying the penalties.

b. Judge Batchelder filed a concurring opinion (Pet. App. 21a-22a). She stated that the court had correctly determined that the "principles of equitable subordination" permit subordination of priority tax claims. In her view, the plain language of the statute mandates that conclusion and "nothing requires us to delve into the legislative history" (*id.* at 22a):

> Section 726(a) [see note 1, *infra*] explicitly, clearly, and unambiguously makes the distribution of the property of the estate subject to the provisions of § 510. Postpetition nonpecuniary

loss tax penalties are therefore subject to equitable subordination. End of story.

INTRODUCTION AND SUMMARY OF ARGUMENT

The court of appeals held in this case that postpetition tax penalties are not to be given the *first* priority that Congress expressly provided for such claims in Sections 503(b)(1)(C) and 507(a)(1) of the Bankruptcy Code. The court held that claims for such penalties are instead to be denied *any* priority and are to be subordinated even to general unsecured claims against the debtor. The court stated that its conclusion results from application of the judge-made "principles of equitable subordination" that Congress codified in Section 510(c) of the Bankruptcy Code. The court reasoned that, because tax penalty claims do not compensate a specific, economic loss incurred by the government, such claims should—as a matter of "fairness" and "justice"—be equitably subordinated to the claims of "creditors who suffered actual losses" (Pet. App. 19a, 20a).

By holding that a tax "penalty" is to be subordinated to all other claims against the debtor's estate, the decision in this case annuls and reverses the precisely opposite set of statutory priorities that Congress enacted. The decision thereby conflicts with the established rule that equitable subordination in bankruptcy does *not* permit a court "to contradict statutory or common law when [it] feels a fairer result may be obtained by application of a different rule" (*Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d 784, 787 (9th Cir.), cert. denied, 423 U.S. 913 (1975)). The doctrine of equitable subordination does not confer a power of statutory nullification on the

bankruptcy courts. Instead, the doctrine has the appropriate and narrow role of deterring "conduct either in acquiring or asserting the claim which is itself inequitable" (*id.* at 788). That traditional rationale obviously would not justify subordination of the tax penalty claims in this case.

By assuming a broad authority to realign statutory priorities based upon a "weighing" or "balancing" of the "equities," the court of appeals has fundamentally transformed and misapplied the judge-made doctrine of "equitable subordination" and unloosed that doctrine from its proper moorings. If courts were permitted to determine, by "balancing" the "equities," whose claims are to be paid first and whose are to be paid last, the carefully constructed scheme of priorities in the Bankruptcy Code would be made superfluous.

ARGUMENT

THE "PRINCIPLES OF EQUITABLE SUBORDINATION" CODIFIED IN SECTION 510(c) OF THE BANKRUPTCY CODE DO NOT, IN THE ABSENCE OF INEQUITABLE MISCONDUCT BY THE GOVERNMENT, AUTHORIZE THE SUBORDINATION OF GOVERNMENTAL CLAIMS FOR POSTPETITION TAX PENALTIES

A. The Doctrine Of Equitable Subordination Does Not Permit A Court To Disregard The Statutory Priorities That Congress Has Enacted Merely Because The Court Concludes That A Different Set Of Priorities Would Be More Equitable, Fair Or Just

1. A postpetition tax penalty is defined by statute to be an administrative expense of the bankruptcy

estate. 11 U.S.C. 503(b)(1)(C). As an "administrative expense," such a penalty has "[f]irst" priority in the distribution of the assets of the estate. 11 U.S.C. 507(a)(1). See also 11 U.S.C. 726(a)(1).[1] As this Court has emphasized, the priority for postpetition tax penalties was enacted by Congress precisely because the enforcement of such penalties is an important and necessary measure for ensuring tax compliance in bankruptcy cases. See *Nicholas* v. *United States*, 384 U.S. 678, 694 (1966); *Boteler* v. *Ingels*, 308 U.S. 57, 61 (1939).

The priorities that Congress has established in the Bankruptcy Code for competing classes of claims apply "[e]xcept as provided in section 510" of the Code. 11 U.S.C. 726(a). Section 510 authorizes only three specific exceptions to the statutory ordering of priorities. First, any claim may be subordinated by agreement. 11 U.S.C. 510(a). Second, claims seeking rescission or damages from sales of the debtor's securities may be subordinated. 11 U.S.C. 510(b). Third, any claim may be subordinated to any other claim "under principles of equitable subordination." 11 U.S.C. 510(c)(1). The question presented in this case is thus not whether "principles of equitable subordination" *may* be applied to priority claims; instead, it is *what* those principles are and *how* they are to be applied to priority claims.

2. The judge-made doctrine of equitable subordination has a clear origin and a limited scope (*In re*

[1] This case involves a liquidation of the debtor's assets under Chapter 7 of the Bankruptcy Code (Pet. App. 2a). The priorities established in Section 507 are made applicable to bankruptcy cases under Chapter 7 by Section 726 of the Bankruptcy Code. See 11 U.S.C. 726(a)(1).

Columbia Ribbon Co., 117 F.2d 999, 1002 (3d Cir. 1941) (emphasis added)):

> [A] court of bankruptcy under its equitable powers may disallow or subordinate a particular claim in bankruptcy which, *because of the fraudulent nature of the claim or the bad faith or improper conduct of the claimant*, ought not in equity and good conscience to be allowed or paid on a parity with other claims.

See also *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d 784, 788 (9th Cir.), cert. denied, 423 U.S. 913 (1975). The issue that is to be resolved "under principles of equitable subordination" is whether (2 Collier Bankruptcy Manual ¶ 510.01[1], at 510-2 (3d ed. 1995)):

> harmful conduct [of the claimant] was directed at other creditors. If it was, the claim which is otherwise provable and allowable should be postponed until the claims of the creditors, who were harmed, have been satisfied.

See *Comstock* v. *Group of Institutional Investors*, 335 U.S. 211, 229 (1948); *Pepper* v. *Litton*, 308 U.S. 295, 311 (1939); A. Herzog & J. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 Vand. L. Rev. 83, 85 (1961).

The limited scope of the doctrine of equitable subordination is reflected in the decisions of this Court. In *Taylor* v. *Standard Gas & Electric Co.*, 306 U.S. 307, 323-324 (1939), the Court held that the claim of a parent corporation against its subsidiary could be subordinated to the claims of preferred stockholders in the subsidiary "based on the equities of the case—the history of spoliation, mismanagement, and faith-

less stewardship of the affairs of the subsidiary by [the parent] to the detriment of the public investors." *Pepper* v. *Litton*, 308 U.S. at 308. In *Pepper* v. *Litton*, the Court held that the claim of a dominant shareholder of a bankrupt corporation could be subordinated to the claims of other creditors where the shareholder had breached his fiduciary duties and engaged in a "planned and fraudulent scheme" that damaged other creditors. *Id.* at 303-306. And, in *Comstock* v. *Group of Institutional Investors*, 335 U.S. 211 (1948), the Court reviewed those decisions and confirmed that "principles of equitable subordination" require the presence of creditor misconduct.

The issue in *Comstock* was whether the claim of a dominant shareholder against the bankrupt could be equitably subordinated even though there was no evidence of misconduct. The Court held that equitable subordination could not apply in those circumstances (335 U.S. at 229):

> It is not mere existence of an opportunity to do wrong that brings the rule into play; it is the unconscionable use of the opportunity afforded by the domination to advantage itself at the injury of the subsidiary that deprives the wrongdoer of the fruits of his wrong. On the findings in this case, the claim of [the parent] was the outgrowth of complicated but legitimate good faith business transactions, neither in design or effect producing injury to the petitioner or the interests for which he speaks.

The doctrine of equitable subordination thus provides a means to redress harmful misconduct of an individual claimant. The premise of any application of

the doctrine of "equitable subordination" to "creditor misconduct" is that Congress has measured the equities of competing classes of claims but has not measured the conduct of the individual creditors who assert those claims. See *Carpenter* v. *Wabash Ry.*, 309 U.S. 23, 28 (1940). Because Congress did not (and indeed cannot) take the conduct of individual creditors into account in enacting a bankruptcy distribution scheme, subordination of a particular claim based upon the inequitable conduct of a specific creditor does not contravene the legislative judgment that Congress has made concerning the relative priorities to be afforded to specified categories of claims. See *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 787.

The doctrine of equitable subordination does not, however, authorize a court to disregard statutory priorities merely because the court concludes that a *different* ordering of priorities would enhance "fairness" or "justice" (Pet. App. 19a). "[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 206 (1988). As the Ninth Circuit explained in *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 787,

> it is important to keep in mind that the chancellor never did, and does not now, exercise unrestricted power to contradict statutory or common law when he feels a fairer result may be obtained by application of a different rule. Courts of equity have long applied standards of conscience to conduct on an individual basis to prevent formally proper but unconscionable applications of legal

> rules; they have not engaged in the practice of making abstract legislative judgments about the fairness of a result contemplated by the legislature's statutory scheme if it has otherwise been followed in good faith and without overreaching.

See also *In re Columbia Ribbon Co.*, 117 F.2d at 1002.[2]

This Court has noted that, in enacting the statutory priority scheme, Congress itself made a "reasonable classification of claims as entitled to priority because of superior equities." *Carpenter* v. *Wabash Ry.*, 309 U.S. at 28. The categorical balancing of equities that Congress made in adopting the Code's priority provisions may not categorically be displaced by the courts under the guise of "equitable subordination." As the Ninth Circuit stated in *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 788, the doctrine of equitable subordination does not permit a court to say, "in effect * * *, 'No, the distribution scheme provided by the [Bankruptcy] Act is a mistake.'"

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[2] Similarly, in *New Jersey* v. *Anderson*, 203 U.S. 483 (1906), the Court rejected the assertion that a statutory priority for state taxes should not be recognized because it created an "injustice" for other creditors and gave the State an undue "advantage" (*id.* at 490):

> [C]onsiderations of this character, however properly addressed to the legislative branch of the government, can have no place in influencing judicial determination. It is the province of the court to enforce, not to make the laws, and if the law works inequality the redress, if any, must be had from Congress.

Courts therefore traditionally and consistently held that "[d]ecisions about the treatment of *categories* of claims in bankruptcy proceedings * * * are not dictated or illuminated by principles of equity and do not fall within the judicial power of equitable subordination." *Burden* v. *United States*, 917 F.2d 115, 122 (3d Cir. 1990) (Alito, J., concurring in part and dissenting in part; emphasis added).[3] See also *Benjamin* v. *Diamond*, 563 F.2d 692, 700 (5th Cir. 1977) (equitable subordination requires that "[t]he claimant must have engaged in some type of inequitable conduct"); *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 788 ("there must be conduct either

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[3] The Third Circuit has placed itself on both sides of this issue. In 1941, the court explained that the doctrine of equitable subordination does not authorize a court to adopt a priority scheme different from the statutory scheme based simply upon the court's "theory of equity." *In re Columbia Ribbon Co.*, 117 F.2d at 1002. Instead, the court explained, equitable subordination may be applied to "disallow or subordinate a particular claim in bankruptcy which, because of the fraudulent nature of the claim or the bad faith or improper conduct of the claimant, ought not in equity and good conscience to be allowed or paid on a parity with other claims." *Ibid.*

In 1990, the Third Circuit acknowledged that, "prior to the enactment of the Bankruptcy [Code] of 1978," the doctrine of equitable subordination had applied "only when there has been a showing of bad faith on the part of the creditor." *Burden* v. *United States*, 917 F.2d at 119. The court identified nothing in the text or history of the 1978 legislation to justify a departure from that historical understanding of equitable subordination. The court stated, nevertheless, that it was persuaded by several recent decisions holding that "creditor misconduct is not a prerequisite for equitable subordination." *Id.* at 120-121. See pages 24-28, *infra*. As described in the text, Judge Alito dissented from that part of the court's opinion.

in acquiring or asserting the claim which is itself inequitable in order to subordinate a claim"); *In re Credit Industrial Corp.*, 366 F.2d 402, 408 (2d Cir. 1966). As the Eighth Circuit stated in *United States* v. *Killoren*, 119 F.2d 364, 366, cert. denied, 314 U.S. 640 (1941), in reversing a decision that had applied "equitable subordination" to a claim for taxes, "[t]he plain mandate of the law cannot be set aside because of considerations which may appeal to referee or judge as falling within general principles of equity jurisprudence."

3. In 1978, Congress codified the judge-made doctrine of equitable subordination as Section 510(c) of the Bankruptcy Code. That provision states that bankruptcy courts may, "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim." 11 U.S.C. 510(c)(1).

By codifying the doctrine of equitable subordination, the statute did not enlarge the equitable authority that courts had previously exercised. The express language of the statute—which refers to "principles of equitable subordination"—indicates that Congress intended courts to exercise the limited equitable powers that had then been established in decisions of this Court and the courts of appeals. The floor statement accompanying Section 510(c)(1) confirms that Congress "intended that the term 'principles of equitable subordination' follow existing case law and leave to the courts development of this principle." 124 Cong. Rec. 32,398 (1978) (Rep. Edwards).

The text and history of Section 510(c) reflect a deliberate policy determination of Congress that "existing case law" was to be followed in applying

"principles of equitable subordination." In enacting the Bankruptcy Code in 1978, Congress considered and rejected statutory language that would have granted bankruptcy courts authority to subordinate claims on much broader grounds. The bill that first passed the House of Representatives contained a version of Section 510(c) that would have allowed any claim to be subordinated simply "on equitable grounds." H.R. 8200, 95th Cong., 1st Sess., § 510 (1977). The report accompanying the House bill emphasized that this language differed from the existing doctrine of equitable subordination, for it would permit the courts to order "subordination on any equitable grounds." H.R. Rep. No. 595, 95th Cong., 1st Sess. 359 (1977). The broad language of the House bill was deleted, however, from the final legislation. The phrase "under principles of equitable subordination" was substituted in its place. See S. Rep. No. 989, 95th Cong., 2d Sess. 74 (1978); 124 Cong. Rec. 32,416 (1978) (Rep. Edwards); *id.* at 34,016 (Sen. DeConcini).[4]

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[4] The Senate Report on the provision enacted as Section 510(c) states (S. Rep. No. 989, *supra*, at 74) (emphasis added):

> [A]ny subordination ordered under this provision must be based on principles of equitable subordination. These principles are defined by case law, and have generally indicated that *a claim may normally be subordinated only if its holder is guilty of misconduct.* As originally introduced, the bill provided specifically that a tax claim may not be subordinated on equitable grounds. The bill deletes this express exception, but the effect under the amendment should be much the same in most situations since, under the judicial doctrine of equitable subordination, a tax claim would rarely be subordinated.

The history of Section 510(c) thus confirms that Congress consciously elected to adopt only the "existing" principles of equitable subordination and rejected a broader equitable authority for the bankruptcy courts. That existing authority rejected application of equitable subordination to displace the categorical priorities enacted by Congress in the absence of particularized misconduct by a specific creditor. See pages 10-16, *supra*. See also *In re Credit Industrial Corp.*, 366 F.2d at 408; 3 *Collier on Bankruptcy* ¶ 510.01 (15th ed. 1995) ("The law in this area is of long standing, having been judicially created.").

B. The Court Of Appeals Misapplied The Doctrine Of Equitable Subordination In Subordinating A Claim In The Absence Of Inequitable Conduct By The Claimant

1. In the present case, the court of appeals acknowledged that the tax penalty claim was not derived from any "misconduct" of the government (Pet. App. 4a).[5] The court also recognized that Congress expressly provided first priority in the distribution of the assets of the estate for such tax penalty claims (*ibid.*, citing 11 U.S.C. 503(b)(1)(B) and (C), 507(a)(1), and 726(a)(1)). The court concluded, however, that Congress acted "unfairly" and "unjustly" in awarding first priority to the government's claims for postpetition tax penalties under Section

[5] Indeed, the claim in this case was derived from the debtor's failure to file a timely return (26 U.S.C. 6651), which represents "misconduct" by the debtor, not the creditor (the United States). Hence, the doctrine of equitable subordination, which applies only to creditor misconduct, has no application here.

503(b)(1)(C) and Section 507(a)(1). The court of appeals "in effect said, 'No, the distribution scheme provided by the Act is a mistake'" (*Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 788). The court stated that it did not "see the fairness or the justice in permitting the Commissioner's claim for tax penalties * * * to enjoy an equal or higher priority with claims based on the extension of value to the debtor, whether secured or not" (Pet. App. 19a). For that reason, the court held that the tax penalty claim should not be given the "[f]irst" priority that Congress specified for that claim. The court held, instead, that the government's claim should be "equitably" subordinated even to the claims of unsecured general creditors (*ibid.*).

The court of appeals erred in applying the doctrine of equitable subordination to annul the statutory priorities established by Congress simply because the court believed that "fairness" and "justice" could be enhanced by a different distribution scheme. Congress directed that postpetition tax penalties are to be given "[f]irst" priority in distribution. 11 U.S.C. 507(a)(1); see 11 U.S.C. 503(b)(1)(C).[6] Even if there

[6] While Section 726(a)(1) preserves first priority in distribution for postpetition tax penalties in Chapter 7 cases (see note 1, *supra*), Section 726(a)(4) expressly subordinates prepetition tax penalties to general unsecured claims. Compare 11 U.S.C. 726(a)(1) with 11 U.S.C. 726(a)(4). The reasoning adopted by the court of appeals in this case is thus invalid for the additional reason that it conflicts with the carefully crafted distinctions that Congress made in enacting Section 726. By requiring subordination of postpetition tax penalties, the decision in this case relegated those penalties to the same status that Congress elected to apply *only* to prepetition tax penalties in Section 726.

were a basis to believe that it might be more "fair" to pay other creditors before postpetition tax penalties are paid, any dispute about the relative merits of alternative priority schemes is simply irrelevant to the task that the court of appeals properly had before it.[7] Congress authoritatively resolved that policy issue when it expressly provided a first priority for postpetition tax penalty claims in Section 503(b)(1)(C) and Section 507(a)(1). Moreover, as this Court explained in enforcing the priority for postpetition tax penalties in *Nicholas* v. *United States*, 384 U.S. at 694, Congress adopted that first priority for postpetiton tax penalty claims precisely because such penalties serve to enforce compliance with the tax laws in bankruptcy cases. See also *Boteler* v. *Ingels*, 308 U.S. at 61. That legislative judgment is obviously binding on the courts and may not be displaced by a court's differing perception of "equity" or "fairness" (Pet. App. 19a). See, *e.g.*, *United States* v. *Sotelo*, 436 U.S. 268, 279 (1978) ("we as judges cannot override the specific policy judgments made by Congress in enacting the statutory provisions with which we are

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Section 726 sets forth the order of distribution in cases under Chapter 7. See 11 U.S.C. 103(b); note 1, *supra*. In cases outside of Chapter 7, prepetition tax penalties are paid on a parity with general unsecured claims. Congress rejected proposals that would have required subordination of prepetition tax penalty claims in cases under all chapters. See *Report of the Commission on the Bankruptcy Laws of the United States*, H.R. Doc. No. 137, 93d Cong., 1st Sess. Pt. II, at 115, § 4-406(a)(3) (1973).

[7] In assessing the "fairness" of the statutory distribution scheme, the court of appeals wholly failed to consider the enforcement function served by tax penalties during the administration of the estate.

here concerned"); *New Jersey* v. *Anderson*, 203 U.S. at 490; note 2, *supra*.

2. In its decision in this case, the court of appeals sought to rely on the 1978 floor statement of Representative Edwards that "existing case law" permits subordination of "a claim * * * of a status susceptible to subordination, such as a penalty" (Pet. App. 11a). As Judge Alito correctly observed in his separate opinion in *Burden* v. *United States*, 917 F.2d at 123, however, that description of "existing case law" by Representative Edwards was simply incorrect. As of 1978, no court had held that tax "penalty" claims, or any other kind of "penalty" claims, were subject to equitable subordination. Prior to 1978, claims for *pre*petition tax penalties were disallowed by statute (not subordinated through exercise of a court's equitable powers) under Section 57(j) of the Bankruptcy Act, 11 U.S.C. 93(j) (1976). See *Simonson* v. *Granquist*, 369 U.S. 38, 40 (1962); Herzog & Zweibel, *supra*, 15 Vand. L. Rev. at 85-88 (noting the difference between claim disallowance and claim subordination). By contrast, claims for *post*-petition penalties incurred by the trustee or debtor in possession—the type of penalties involved in this case—were allowable and were given first priority in distribution of the bankruptcy estate. *Nicholas* v. *United States*, 384 U.S. at 692-695; *Boteler* v. *Ingels*, 308 U.S. at 61; *In re Samuel Chapman, Inc.*, 394 F.2d 340, 341-342 (2d Cir.), cert. denied, 393 U.S. 923 (1968).[8]

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[8] The majority and concurring opinions in this case (Pet. App. 12a-13a, 22a) thus simply erred in stating, without qualification, that penalty claims were disallowed under the former Bankruptcy Act.

Any misdescription of "existing case law" in the 1978 floor statement of Representative Edwards obviously does not alter the preexisting "principles of equitable subordination" that are to be applied under Section 510(c)(1). See *Burden* v. *United States*, 917 F.2d at 123 (Alito, J., concurring in part and dissenting in part). Moreover, although it is unclear what "penalty" Representative Edwards may have had in mind in asserting that penalty claims were of a status "susceptible to subordination," he obviously was not contemplating that postpetition tax penalty claims would be subordinated under Section 510(c)(1) when Section 503(b)(1)(C) of the *same* Act provides "[f]irst" priority for such claims. See 11 U.S.C. 503(b)(1)(C). Indeed, Representative Edwards went on to say in the next portion of his remarks (124 Cong. Rec. 32,416 (1978)):

> Since the House amendment authorizes subordination of claims only under principles of equitable subordination, and thus incorporates principles of existing case law, a tax claim would rarely be subordinated under this provision of the bill.

See also *id.* at 34,016 (Sen. DeConcini); S. Rep. No. 989, *supra*, at 74 (noting that, "under the judicial doctrine of equitable subordination, a tax claim would rarely be subordinated" for "a claim may normally be subordinated only if its holder is guilty of misconduct"); note 4, *supra*.

The suggestion that tax penalty claims are categorically of a "status susceptible to subordination" is also refuted by the careful distinctions that Congress made in providing disparate treatment for prepetition and postpetition tax penalties. Section

726 provides first priority for claims for *post*petition tax penalties but subordinates claims for *pre*petition penalties to general unsecured claims. See note 6, *supra*. The precisely formulated legislative judgment that Congress made in Section 726 may not be annulled by a judicial conclusion that "fairness" and "justice" require that some different priority scheme apply.

As this Court has noted, Congress has long provided first priority for postpetition tax penalties as a "legitimate means to enforce" compliance with the tax laws in bankruptcy cases. *Nicholas* v. *United States*, 384 U.S. at 694. By effectively ensuring that claims for postpetition penalties will not be paid from the assets of bankruptcy estates, the decision in this case would allow debtors-in-possession and trustees to disregard their legal obligations with impunity.[9] Allowing violations of the law to go unsanctioned and undeterred is neither "fair," nor "equitable," nor good "policy"—as Congress authoritatively determined by providing first priority for the payment of such claims. As this Court has recognized, the priority for postpetition tax penalties in bankruptcy exists precisely to ensure that debtors abide by the same rules of law that apply to every other business

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[9] The court of appeals erred in suggesting (Pet. App. 19a) that the tax penalties involved in this case can be collected by the government even if that claim is subordinated in the liquidation proceedings. The court reasoned that ultimate collection is assured because the "debtor-in-possession remains liable individually for the postpetition tax penalties" (*ibid.*). In making that statement, however, the court seems to have forgotten that this case involves a liquidation under Chapter 7. After such a liquidation, the debtor will have no assets available to pay any unsatisfied, subordinated tax penalty claim.

(including those with whom they compete). *Nicholas* v. *United States*, 384 U.S. at 694; *Boteler* v. *Ingels*, 308 U.S. at 61. See also *United States Department of Interior* v. *Elliott*, 761 F.2d 168, 171 (4th Cir. 1985).[10]

3. a. Other courts have also recently held that "principles of equitable subordination" are *not* confined to remedying creditor misconduct and instead permit courts categorically to subordinate "penalty" claims to the claims of other creditors who have incurred an "actual loss" (Pet. App. 20a). See *Burden* v. *United States*, 917 F.2d at 119-120; *In re Virtual Network Services Corp.*, 902 F.2d 1246, 1248-1250 (7th Cir. 1990); *Schultz Broadway Inn* v. *United States*, 912 F.2d 230, 232-234 (8th Cir. 1990); *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, 53 F.3d 1155 (10th Cir. 1995), cert. granted, No. 95-325 (Dec. 1, 1995). In these other cases, as here, the courts reasoned that subordination of a tax penalty claim is appropriate to ensure that payment of the penalty does not reduce the assets available for other claimants.

In so holding, these courts acknowledged that, prior to enactment of the Bankruptcy Code in 1978, the "existing case law" had held that the doctrine of equitable subordination required a showing of creditor misconduct. See, *e.g.*, *In re Virtual Network*

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[10] In *United States Department of Interior* v. *Elliott*, the court further explained the rationale for granting statutory priority to claims for postpetition penalties even though such claims may deplete the assets available to other creditors. Creditors may influence the debtor-in-possession or trustee to allow such penalties to accrue and should not be permitted to benefit from the false economies recognized by the estate through its failure to comply with applicable nonbankruptcy law. 761 F.2d at 171.

Services Corp., 902 F.2d at 1248, citing *Pepper* v. *Litton*, 308 U.S. at 304-305. The courts also recognized that Congress intended such "existing case law" to apply in any future elaboration of the "principles of equitable subordination" (902 F.2d at 1248; Pet. App. 11a). They reasoned, however, that the history of the 1978 Bankruptcy Code indicates that such older authority is not necessarily binding because "Congress intended courts to continue developing the principles of equitable subordination." *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, 53 F.3d at 1158, citing *In re Virtual Network Services Corp.*, 902 F.2d at 1249-1250. The courts relied for this conclusion on the portion of the floor statement of Representative Edwards which states (124 Cong. Rec. 32,398 (1978)):

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle.

Read as a whole, however, this sentence cannot logically be understood to suggest that courts may, in the "development of this principle," establish "principles of equitable subordination" that *conflict* with the "existing case law" that, as of 1978, had concluded that equitable subordination could *not* be applied to discard the categorical classifications of priorities that Congress enacted in the Code. Such a reading would place one part of that sentence at war with the other part.

Instead, this sentence from the floor statement indicates only that equitable subordination is a judicially created remedy that should be applied compatibly with the prior case law. The statement

cannot properly be read—as the court read it in this case (Pet. App. 18a)—as an invitation to *depart* fundamentally from prior case law by substituting the court's judgment about the comparative equities of classes of claims for the judgment that Congress itself has made.

b. The only authority cited by these courts as evidence of the "developing" principles of equitable subordination is the Second Circuit's decision in *In re Stirling Homex Corp.*, 579 F.2d 206 (1978), cert. denied, 439 U.S. 1074 (1979). In that case, the court of appeals held that the claims of shareholders who alleged that they were defrauded in purchasing stock of the debtor should be subordinated to general unsecured claims because "the equities favor the conventional general creditors rather than the allegedly defrauded stockholders." *Id.* at 213. The court noted that the claims of these stockholders for the recovery of their capital contributions are claims asserted in their capacity *as shareholders*. *Ibid.* The court held that the claims of shareholders brought in their capacity *as shareholders*, rather than in the capacity of a trade or business creditor, should not be treated on a parity with the claims of general unsecured creditors. *Ibid.*[11] In so holding, the court cited and relied (*ibid.*) on the authority of *Newton National Bank* v. *Newbegin*, 74 F. 135, 140 (1896), where the Eighth Circuit stated that the temptation for stockholders to attempt to "lay aside the garb of a

[11] *Stirling Homex* involved an attempt by equity shareholders who allegedly were defrauded in the purchase of the debtor's securities to *elevate* their priority in the corporate bankruptcy from last priority (as equity holders) to that of unsecured creditors (as tort claimants). 579 F.2d at 211-213.

stockholder, on one pretense or another, and to assume the role of a creditor, is very strong, and all attempts of that kind should be viewed with suspicion."

Other courts have suggested that *Stirling Homex* is an example of a "developing" principle of equitable subordination under which courts should make a "case-by-case" evaluation of the equities and should not require actual proof of creditor misconduct. In *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, 53 F.3d at 1159, quoting *In Re Virtual Network Services Corp.*, 902 F.2d at 1250, the court broadly stated:

> [Section] 510(c)(1) authorizes courts to equitably subordinate claims to other claims on a case-by-case basis without requiring in every instance inequitable conduct on the part of the creditor claiming parity among other unsecured general creditors.

But nothing in *Stirling Homex* provides support for the proposition that courts may apply "equitable subordination" categorically to alter the distribution scheme that Congress enacted. The Second Circuit did not mention, much less question, the well-established case law holding that courts may not disregard the statutory priority scheme based on their contrary view of what is "fair" or "just." Instead, the decision in *Stirling Homex* was based upon the necessity of determining whether the claims of the shareholders were for the recovery of capital—and therefore to be paid only *after* general unsecured claims—or were instead business and trade claims properly to be treated on a parity with the general unsecured claims brought by strangers to the

corporation. The Second Circuit concluded in *Stirling Homex* that the claims of shareholders that stem from their status *as shareholders* are capital in nature and are therefore subordinated, under ordinary priority principles, to creditor claims. 579 F.2d at 213. See, *e.g.*, *Louisville Trust Co.* v. *Louisville, N.A. & C. Ry.*, 174 U.S. 674, 684 (1899) (noting the "familiar rule that the stockholder's interest in the property is subordinate to the rights of creditors").

Stirling Homex is thus a particular application of, not a negation or nullification of, the statutory priority classification scheme that Congress has enacted.[12] Under that scheme, the interests of shareholders in the capital of the corporation is compensated only *after* the claims of general unsecured creditors are paid. See 11 U.S.C. 726(a)(6).

4. The doctrine of equitable subordination does not permit courts to act as committees of legislative review to promulgate priority schemes that are more closely aligned with their view of "fairness or * * * justice" (Pet. App. 19a). The categorical judicial re-evaluation of the "equities" of competing classes of claims authorized by the decision of the court of appeals in this case would create harmful uncertainties for private, as well as public, creditors. An unfettered "equitable" authority to adjust statutory priorities to enhance "fairness" would threaten "the financial community [by calling] into

[12] The rule articulated in *Stirling Homex* was codified in Section 510(b) of the Bankruptcy Code (11 U.S.C. 510(b)) and was described in the 1978 floor statement of Representative Edwards as an example of "existing case law." See Pet. App. 11a.

question the future of bankruptcy priority." Note, *No Fault Equitable Subordination: Reassuring Investors That Only Government Penalty Claims Are At Risk*, 34 Wm. & Mary L. Rev. 487, 488 (1993). Under the theory applied by the court of appeals in this case, it could be questioned whether, for example, claims for punitive damages would be regarded as subject to subordination because "inequitable" (in the sense of not involving "actual losses" (Pet. App. 19a)) or, instead, entitled to preferential treatment because "equitable" (in the sense of being designed to promote the public purpose of deterring malicious behavior). Similarly, postpetition governmental "penalty" claims designed to deter violations of health and safety regulations would plausibly be subject to subordination on the theory adopted by the court of appeals in this case—because they do not compensate the government for "pecuniary loss" and may reduce the recovery of other claimants (*ibid.*).

The establishment of categorical priorities among competing, innocent claimants has never been the function of the judiciary in bankruptcy cases. In the Bankruptcy Code itself, Congress specified the priorities that innocent claimants are to receive. See 11 U.S.C. 507, 726. By ignoring those statutory priorities—and, indeed, adopting a precisely opposite set of priorities in this case—the decision of the court of appeals represents a marked departure both from the common understanding of "equitable" authority and from the specific understanding of the doctrine of "equitable subordination" that Congress codified in 1978 in Section 510(c) of the Bankruptcy Code.[13]

[13] This case will be argued in tandem with *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, No. 95-425,

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

DREW S. DAYS, III
Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

KENT L. JONES
Assistant to the Solicitor General

GARY D. GRAY
EDWARD T. PERELMUTER
Attorneys

JANUARY 1996

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which presents a closely analogous question concerning the proper scope of the "principles of equitable subordination" in bankruptcy cases. We have furnished a copy of the brief for the United States in *Reorganized CF&I Fabricators* to counsel for the respondents in this case. We have also furnished a copy of the brief for the United States in this case to counsel for the respondents in *Reorganized CF&I Fabricators*.

(5)

No. 95-323

Supreme Court, U.S.
FILED
FEB 29 1996
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In The

Supreme Court of the United States

October Term, 1995

UNITED STATES OF AMERICA,

Petitioner,

vs.

THOMAS R. NOLAND, TRUSTEE FOR DEBTOR FIRST TRUCK LINES, INC.,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

BRIEF FOR RESPONDENT

RAYMOND J. PIKNA, JR.
Counsel of Record
THOMAS R. NOLAND
ROBERT B. BERNER
GREGORY P. GARNER
ALTICK & CORWIN CO., L.P.A.
Attorneys for Respondent
1700 One Dayton Centre
One South Main Street
Dayton, Ohio 45402
(513) 223-1201

7617
Lutz Appellate Services, Inc.
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QUESTION PRESENTED

The Bankruptcy Code does not define the term "principles of equitable subordination." A pecuniary loss claim is susceptible to equitable subordination if there has been misconduct by the claimant. Enforcement of a nonpecuniary loss tax penalty claim against a bankruptcy estate would serve not to punish the delinquent taxpayer, but rather its entirely innocent creditors. Five circuit courts of appeals considering the application of 11 U.S.C. § 510(c) have concluded that nonpecuniary loss tax penalty claims may be equitably subordinated pursuant to 11 U.S.C. § 510(c) without a finding of governmental misconduct. This case presents the following question:

Whether the bankruptcy court in a chapter 7 case of a liquidated corporate debtor properly exercised its discretion under 11 U.S.C. § 510(c)(1) to equitably subordinate the administrative expense nonpecuniary loss tax penalty claims of the IRS to the actual pecuniary loss claims of entirely innocent claimants, including the actual pecuniary loss claims of general unsecured creditors, when the nonpecuniary loss tax penalty claims arose after the corporate debtor filed its chapter 11 petition but before its case was converted to chapter 7.

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Respondent, Thomas R. Noland, Trustee for Debtor First Truck Lines, Inc. (the "Trustee"), respectfully requests that this Court affirm the judgment of the United States Court of Appeals for the Sixth Circuit in this case. The opinion of the court of appeals (Pet. 1a-22a) is reported at 48 F.3d 210.

STATEMENT OF THE CASE

1. First Truck Lines, Inc. ("FTL") filed its chapter 11 petition on April 10, 1986 (Pet. App. 2a). FTL's chapter 11 plan was confirmed by order entered June 2, 1987 (Resp. App. 3a). The nonpecuniary loss tax penalty claims of the Internal Revenue Service ("IRS") at issue are for the tax period ended December 31, 1987 and for the post-confirmation tax quarters ended September 30, 1987, March 31, 1988, and June 30, 1988, respectively (Resp. App. 7a). The case was converted to chapter 7 on August 1, 1988, and Thomas R. Noland was appointed Trustee for FTL (Pet. App. 2a). Petitioner and the Trustee applied to the bankruptcy court for a determination of the priority, if any, to be accorded to the nonpecuniary loss tax penalty claims of the IRS (Resp. App. 11a, 12a).

2. After finding that the nonpecuniary loss tax penalty claims of the IRS were administrative expenses (Pet. App. 40a, 53a), the bankruptcy court considered whether those claims should be subordinated pursuant to 11 U.S.C. § 510(c)(1), which provides:

> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may —
>
> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an

> allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest . . .

(Pet. App. 42a). Because the Bankruptcy Code does not define the term "equitable subordination," the bankruptcy court then examined the legislative history, which states that the term is to follow existing case law and that its meaning is to be developed by the courts:

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if the holder of such claim is guilty of inequitable conduct, *or the claim itself is of a status susceptible to subordination, such as a penalty* or a claim for damages arising from the purchase or sale of a security of the debtor.

124 Cong. Rec. H11,089, H11,095 (Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. S17,406, S17,412 (Oct. 6. 1978) (statement of Sen. DeConcini) (Pet. App. 43a, emphasis added by court).

The bankruptcy court adopted the rationale of *In re Virtual Network Services Corp.*, 902 F.2d 1246 (7th Cir. 1990), *Schultz Broadway Inn v. United States*, 912 F.2d 230 (8th Cir. 1990), and *Burden v. United States*, 917 F.2d 115 (3d Cir. 1990), that no creditor misconduct was required to subordinate the nonpecuniary loss tax penalty claims of the IRS pursuant to 11 U.S.C. § 510(c)(1), then weighed the various equities of the

claims (Pet. App. 44a-48a). Although finding that "[p]enalties may punish a debtor who is attempting to reorganize and may insure that the debtor obeys the tax laws," the court recognized that "in a Chapter 7 liquidation or in a liquidating chapter 11, the parties who are punished are other creditors because payment of penalties reduces estate assets available for distribution" and rejected the IRS's assertion that "requiring debtors to pay penalties which are administrative expenses does not punish innocent creditors, but rather insures that chapter 11 debtors obey the law while they are under the protection of the bankruptcy court" (Pet. App. 48a-49a).

> Weighing the foregoing against the Code's preference for compensating actual loss claims, and the fact that, in this liquidation proceeding, it appears the total amount of assets to be distributed will fully compensate only the first priority claim holders and will be distributed on a *pro rata* basis to the second priority claim holders, the court concludes that the equities tilt in favor of subordinating the postpetition non-pecuniary loss tax penalties sought by the IRS.

(Citations omitted) (Pet. App. 49a- 50a).

3. The district court affirmed (Pet. App. 26a-33a), first concluding that the equitable subordination provisions of 11 U.S.C. § 510 apply to administrative claims pursuant to the plain language of 11 U.S.C. § 726(a) (Pet. App. 30a), then concluding that the bankruptcy court properly balanced the equities:

> . . . . The IRS's claim for tax penalties is unquestionably a penalty, an additional

assessment, so to speak, for the debtor's having failed to pay the taxes and the interest due on the taxes in a timely manner, sums which, unlike the statutory penalties, represent actual losses (or the loss of the use of money) to the IRS. The IRS has priority to its claims for unpaid taxes and for interest on those taxes; therefore, it will not suffer a pecuniary loss if it does not obtain priority for the tax penalties. The same cannot be said for other creditors; rather, those persons provided value to FTL and will not receive that for which they bargained if the IRS is to be given priority for sums which do not represent out of pocket losses to it. Accordingly, this Court concludes that the equities tip in favor of subordinating the IRS's claim for tax penalties in this case.

(Footnote omitted) (Pet. App. 32a-33a).

4. The court of appeals, Judge Batchelder concurring, affirmed (Pet. App. 1a-22a). In seeking to reverse the lower court's decision, the IRS relied on the court of appeals' prior decision in *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055 (6th Cir. 1991), *cert. denied*, 502 U.S. 1092 (1992), as well as on three pre-1978 decisions of this Court which analyzed equitable subordination of certain pecuniary loss claims in light of alleged misconduct by the dominant shareholder (Pet. App. 5a, citing *Comstock v. Group of Institutional Investors*, 335 U.S. 211 (1948); *Pepper v. Litton*, 308 U.S. 295 (1939); and *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307 (1939)). The court of appeals observed:

> . . . . The view of the Commissioner, while partially correct, constitutes an incomplete

> understanding of *Mansfield Tire*. This Court also said in *Mansfield Tire* that, while a bankruptcy court may not impose its own view of equity where Congress has set priorities, Section 510(c) expressly permits a bankruptcy court to apply the "principles of equitable subordination" to subordinate a claim "otherwise susceptible to subordination, such as a penalty."

(Pet. App. 5a). The appellate court also noted that the *Mansfield Tire* case did not address whether a tax penalty claim was susceptible to subordination, and that the Supreme Court cases cited by the IRS did not address the precise question before the court of appeals (Pet. App. 6a).

The court of appeals followed the analysis of the bankruptcy court and agreed that the legislative history of 11 U.S.C. § 510(c) indicates that a nonpecuniary loss tax penalty is properly subject to equitable subordination. First, at the time of enactment of the Bankruptcy Code on November 6, 1978, the case law on the principles of equitable subordination included *Comstock*, *supra*, *Pepper*, *supra*, and *Taylor*, *supra*, as well as one appellate case, *In re Stirling Homex Corp.*, 579 F.2d 206 (2d Cir. 1978), *cert. denied*, 439 U.S. 1074 (1979) (subordinating the claims of defrauded shareholders, even though they were not guilty of misconduct) (Pet. App. 12a). Second, citing section 57(j) of the former Bankruptcy Act, 11 U.S.C. § 93(j) (repealed), the absence of case law equitably subordinating tax penalty claims prior to the enactment of the Bankruptcy Code was because nonpecuniary loss tax penalty claims were not allowed by law (Pet. App. 12a). Third, the Supreme Court had interpreted § 93(j) broadly to disallow both secured and unsecured claims for tax penalties against the estate of the bankrupt (Pet. App. 12a-13a, citing *Simonson v. Granquist*, 369 U.S. 38 (1962)). Finally, the

court of appeals noted that three other federal appellate courts had held that claims for prepetition nonpecuniary loss tax penalties may be equitably subordinated in the appropriate case even though no governmental misconduct occurred, and that the reasoning of those cases was equally applicable to postpetition nonpecuniary loss tax penalty claims (Pet. App. 13a-14a, citing *Burden v. United States*, 917 F.2d 115 (3d Cir. 1990); *In re Virtual Network Services Corp.*, 902 F.2d 1246 (7th Cir. 1990); and *Schultz Broadway Inn v. United States*, 912 F.2d 230 (8th Cir. 1990)).

The court of appeals next focused on the distinction between pecuniary loss, or compensatory, penalties, and nonpecuniary loss, or punitive, penalties. That distinction is evident not only in 11 U.S.C. § 726, but also appears in the legislative history to 11 U.S.C. §§ 502, 505, and 507. The court of appeals determined that in light of the legislative history and the distinction made between pecuniary and nonpecuniary loss tax penalties, Congress intended the punitive nonpecuniary loss tax penalties to be subject to equitable subordination pursuant to 11 U.S.C. § 510(c) (Pet. App. 14a-17a).

> The essence of bankruptcy is equity. While Congress has over the years re-codified traditional notions of equity, the current Code vests in the bankruptcy court significant discretion and equitable powers. However, the bankruptcy court's equitable subordination powers must be exercised within the confines of the Bankruptcy Code. *In re Granger Garage, Inc.*, 921 F.2d 74, 77 (6th Cir. 1990). An examination of the Code reveals that the bankruptcy courts have the power to subordinate any claim to any other claim under the principles of equitable

> subordination; Congress has left the development of those principles to the courts. The wisdom of such a course is obvious, given the many ways in which parties to a bankruptcy seek advantage in recouping losses. We do not see the fairness or the justice in permitting the Commissioner's claim for tax penalties, which are not being assessed because of pecuniary losses to the Internal Revenue Service, to enjoy an equal or higher priority with claims based on the extension of value to the debtor, whether secured or not. Further, assessing tax penalties against the estate of a debtor no longer in existence serves no punitive purpose. Because of the nature of postpetition, nonpecuniary loss tax penalty claims in a Chapter 7 case, we believe such claims are susceptible to subordination. To hold otherwise would be to allow creditors who have supported the business during its attempt to reorganize to be penalized once that effort has failed and there is not enough to go around.

(Pet. App. 18a-19a). Having determined that nonpecuniary loss tax penalty claims were subject to equitable subordination pursuant to 11 U.S.C. § 510(c), the court of appeals then considered whether the equities had been properly balanced in this case, and affirmed the decision of the district court (Pet. App. 20a).

Judge Batchelder concurred only to express her view that 11 U.S.C. § 726(a) was clear and unambiguous, and that there was no reason to speculate as to Congressional intent concerning that

section (Pet. App. 21a). Judge Batchelder agreed that it was proper to explore the legislative history behind 11 U.S.C. § 510(c) in order to determine Congressional intent concerning the undefined term "principles of equitable subordination," and concluded (Pet. App. 22a):

> Section 726(a) explicitly, clearly, and unambiguously makes the distribution of the property of the estate subject to the provisions of § 510(c). Postpetition non-pecuniary loss tax penalties are therefore subject to equitable subordination. End of story.

INTRODUCTION AND SUMMARY OF ARGUMENT

The court of appeals held that a postpetition punitive nonpecuniary loss tax penalty claim may on a case by case basis be subordinated pursuant to 11 U.S.C. § 510(c)(1) to the claims of parties who gave value to the debtor. This holding is consistent with the plain meaning of 11 U.S.C. § 510(c)(1), is consistent with longstanding bankruptcy policy that provides similar treatment to similar claims, and is consistent with providing superpriority pursuant to 11 U.S.C. § 364(c) over any or all administrative expense claims to parties who support a trustee or debtor in possession in the operation of a business during a chapter 11 case.

Tax penalties are intended to punish persons who have been guilty of some default or wrong; the enforcement of penalties against bankruptcy estates is disfavored because it would punish entirely innocent creditors rather than the delinquent taxpayers. *Simonson v. Granquist*, 369 U.S. 38, 40-41 (1962). Whereas compensatory pecuniary loss tax penalty claims are treated like

other pecuniary loss claims, including compensatory pecuniary loss tax claims, the Bankruptcy Code subordinates disfavored punitive nonpecuniary loss tax penalty claims. *See* 11 U.S.C. § 507(a)(7)(G);[1] 11 U.S.C. § 726(a)(4). It is also clear from the remainder of the statutory scheme that nonpecuniary loss tax penalty claims are disfavored and may be treated differently from pecuniary loss claims.

The lower courts have held that the postpetition nonpecuniary loss tax penalty claims in this case are administrative expenses under 11 U.S.C. § 503(b)(1)(C). The decisions of other courts which determine the *allowance* of postpetition claims as administrative expense claims but do not address whether those allowed claims can be subordinated, and the prior decisions of this Court permitting the subordination of the *pecuniary* loss claims of dominant shareholders who engaged in misconduct or breached their fiduciary duties to other creditors, are not controlling in this case whose only issue is the *subordination* of allowed postpetition punitive *nonpecuniary* loss tax penalty claims.

Nonpecuniary loss tax penalty claims, by their very nature, are susceptible to subordination pursuant to 11 U.S.C. § 510(c)(1) without a finding of misconduct on the part of the claimant. It is also evident from the legislative history that the development of the principles of equitable subordination is left to the courts. It would be improper to carve out a broad exception to 11 U.S.C. § 510(c) for tax penalties when the statute on its face

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1. Prepetition taxes were given sixth priority when the Bankruptcy Code was enacted. 11 U.S.C. § 507(a)(6) (1982). Section 507(a) has been amended twice since then to include additional categories of priority claims payable before prepetition taxes. Prepetition taxes thus currently receive eighth priority. 11 U.S.C. § 507(a)(8). Because the priority for prepetition taxes was seventh at all times relevant to this case, we refer to it herein as "seventh" priority and cite to it as 11 U.S.C. § 507(a)(7).

permits the subordination for purposes of distribution of all or part of an allowed claim of any priority ranking to all or part of another allowed claim. The scales of justice should not be shackled, but should instead be permitted to move freely so that courts may balance the equities of competing claims on a case by case basis and determine whether subordination pursuant to 11 U.S.C. § 510(c) is proper.

Because 11 U.S.C. § 510(c)(1) permits the subordination of postpetition punitive nonpecuniary loss tax penalty claims and because the balance of the equities in this case favor general unsecured creditors who suffered actual losses, as opposed to the IRS, which retains priority for its compensatory tax and interest claims but suffered no actual loss on account of its nonpecuniary loss tax penalty claim, subordination of the postpetition nonpecuniary loss tax penalty claims of the IRS was proper in this case and the decision of the court of appeals should be affirmed.

ARGUMENT

EQUITABLE SUBORDINATION OF THE POSTPETITION NONPECUNIARY LOSS TAX PENALTY CLAIMS OF THE IRS PURSUANT TO 11 U.S.C. § 510(c) WAS PROPER.

After vigorously opposing the application of 11 U.S.C. § 510(c) to administrative expense nonpecuniary loss tax penalty claims (Pet. App. 4a-5a), the IRS has finally conceded that it is unable to evade the plain meaning of 11 U.S.C. § 726(a),[2]

2. Section 726(a) provides in pertinent part:

> (a) Except as provided in section 510 of this title, property of the estate shall be distributed —

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which makes the principles of equitable subordination set forth in 11 U.S.C. § 510 applicable to its claims. Brief for the United States (hereinafter "Brief") at 10. The issue before this Court is whether bankruptcy courts will be permitted to weigh the equities of competing claims on a case by case basis, as expressly permitted by 11 U.S.C. § 510(c)(1), and in an appropriate case subordinate the postpetition punitive nonpecuniary loss tax penalty claims of the IRS to the pecuniary loss claims of parties who gave value to the debtor.

The task of determining the meaning of 11 U.S.C. § 510(c)(1) begins with the language of the statute itself. *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 241 (1989). Section 510(c)(1) of the Bankruptcy Code provides:

> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may —
>
> (1) under principles of equitable

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> (1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title, proof of which is timely filed under section 501 of this title or tardily filed before the date on which the trustee commences distribution under this section;
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> • • •
>
> (4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim . . .

> subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest . . .

Although it is clear from the plain meaning of 11 U.S.C. § 726(a) that the principles of equitable subordination may be applied to any claim in a chapter 7 case, the term "principles of equitable subordination" is not defined in the Bankruptcy Code. Petitioner requests that this Court create an exception to exclude *all* tax penalties from the operation of 11 U.S.C. § 510(c)(1) unless there is inequitable conduct by the IRS. Such an exception is contrary to the statute and would undermine the flexibility necessary for the proper operation of the Bankruptcy Code.

A. Since Nonpecuniary Loss Claims Are Fundamentally Different from Pecuniary Loss Claims, They May Be Treated Differently.

The underlying theme of bankruptcy law is equality of distribution. This has been recognized both under the former Bankruptcy Act, *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941), and under the Bankruptcy Code. *Begier v. Internal Revenue Service*, 496 U.S. 53, 58 (1990). That theme, which recognizes that similar claims should receive similar treatment, is generally implemented through broad categories for classifying claims, exemplified by 11 U.S.C. § 507, and by providing for the orderly distribution to classes of claims, exemplified by 11 U.S.C. § 726. It is undisputed that both the classification of categories of claims in bankruptcy cases, as well as the order of distribution to those claimants, have been fixed by the statutory provisions enacted by Congress. Petitioner asserts, however, that the application of the principles of equitable

subordination on a case by case basis to subordinate punitive nonpecuniary loss tax penalties in an appropriate case improperly creates a new class of claims. Brief at 9-18.[3] The five

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3. The IRS cites *In re Columbia Ribbon Co.*, 117 F.2d 999 (3d Cir. 1941) and *United States v. Killoren*, 119 F.2d 364 (8th Cir. 1941), *cert. denied*, 314 U.S. 640 (1941), for the proposition that bankruptcy courts cannot, by granting a priority which they deem equitable, set up a subclass having priority within a class. *Columbia Ribbon*, 117 F.2d at 1001; *Killoren*, 119 F.2d at 366. In both cases insufficient funds were available to pay administrative expense claims. Under section 64a of the former Bankruptcy Act, 11 U.S.C. § 104a (repealed), administrative expenses shared on a *pro rata* basis in the funds available for payment, regardless of whether the administrative expenses were incurred during the reorganization period or during the liquidation period.

In contrast to the facts of this case, all claimants in *Columbia Ribbon* and *Killoren* gave value to the estates and suffered pecuniary losses, and the courts were effectively asked to grant a superpriority to the administrative expenses incurred in the liquidation period over the administrative expenses incurred in the reorganization period. Notwithstanding its stated refusal to set up a subclass of claims, the *Columbia Ribbon* court nonetheless paved the way for the lower court to engage in the ultimate subordination of administrative expense claims by disallowing them:

> Since the Bankruptcy Act now permits creditors, stockholders and their counsel who assist in a reorganization effort to receive allowances even if a reorganization is not effected, the apparent injustice of permitting counsel for the stockholders and the creditors' committee to share pro rata with the trustees and their counsel and the trustees' creditors in a fund which is inadequate to pay them all in full is not ground for altering the scheme of priority fixed by the statute. We think, however, that in making such allowances in a proceeding where reorganization has failed, the court should fix the amount of the allowances in the light of the fund available for administration expenses and of other claims upon that fund. Where, as here, the fund is found inadequate, the court, *in the exercise of its discretionary power*, may well reconsider and reduce

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federal courts of appeals which have considered whether nonpecuniary loss tax penalty claims may be subordinated pursuant to 11 U.S.C. § 510(c)(1) have rejected that proposition, and uniformly agree that subordination is not automatic and must be determined on a case by case basis.[4] Those courts have merely

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> unpaid allowances previously made to parties in interest and their counsel (even remitting the latter altogether to their clients for their compensation) if it is deemed necessary to do so in order to provide more adequately for the payment of the allowances made to the court's own officers - the trustees - and their counsel and payment of the claims of the trustees' creditors.

(Emphasis added). *Columbia Ribbon*, 117 F.2d at 1002-03. In other words, the equities of the competing administrative expense pecuniary loss claims could be weighed, and because the reorganization was not successful, the harsh remedy of disallowance of the reorganization period claims could be imposed, thereby enhancing the distribution to the liquidation period administrative expense claimants having equal priority - a result which seems contrary to the court's reasoning, but which is consistent with the court's exercise of its discretionary power to subordinate for purposes of distribution all or part of and allowed claim to all or part of another allowed claim pursuant to 11 U.S.C. § 510(c).

4. *In re Virtual Network Services Corp.*, 902 F.2d 1246, 1250 (7th Cir. 1990) ("... we conclude that § 510(c)(1) authorizes courts to equitably subordinate claims to other claims on a case-by-case basis without requiring in every instance inequitable conduct on the part of the creditor claiming parity among other unsecured general creditors."); *Schultz Broadway Inn v. United States*, 912 F.2d 230, 234 (8th Cir. 1990) ("... we do observe that in an appropriate case circumstances may arise such that the bankruptcy court, after consideration of the relative equities, may determine that subordination should not apply to the Government's non-pecuniary loss claims vis-a-vis the actual loss claims of some or all creditors."); *Burden v. United States*, 917 F.2d 115, 119 (3d Cir. 1990) ("While we agree with the district court and the debtor that equitable subordination of nonpecuniary loss tax penalties is permissible,

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applied 11 U.S.C. § 510(c)(1) according to its plain meaning to *permit*, under principles of equitable subordination, the subordination for purposes of distribution of all or part of an allowed claim to all or part of another allowed claim. The effect of the subordination is merely to adjust the equities among claimants and to regulate distribution.[5] A. Herzog and J. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 Vand. L. Rev. 83, 87 (1961).

It would be improper to shackle the scales of justice and carve out a broad exception to 11 U.S.C. § 510(c)(1) which would place all tax penalties beyond the reach of the equitable powers of the court unless there is inequitable conduct by the government. Section 510(c)(1) requires that each penalty be evaluated on its merits relative to other allowed claims. The payment of a nonpecuniary loss tax penalty may have a

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we also believe that Congress did not intend such a radical alteration in the equitable subordination doctrine as to permit automatic subordination simply because the claim is for nonpecuniary loss tax penalties. Such a major revision in the bankruptcy law would certainly warrant explicit direction from Congress." The court of appeals then reversed and remanded to the district court because it erred as a matter of law by subordinating the nonpecuniary loss tax penalty claims of the IRS without considering the equities involved in the various claims."); *In re First Truck Lines, Inc.*, 48 F.3d 210, 218 (6th Cir. 1995), *cert. granted*, No. 95-323 (December 1, 1995) ("Our decision today does not mean that every tax penalty assessed by the Commissioner will be equitably subordinated.") (Pet. App. 20a); *In re CF & I Fabricators of Utah, Inc.*, 53 F.3d 1155, 1159 (10th Cir. 1995), *cert. granted*, No. 95-325 (December 1, 1995) (following *Virtual Network Services*, *supra*, and concluding that the bankruptcy court correctly addressed the equities in the case).

5. When a claim is subordinated, the funds which would have been distributed to that claimant are distributed instead to the non-subordinated claimants until they are paid to the extent allowed by the court. The application of the doctrine of equitable subordination is illustrated by the hypothetical printed in Appendix A, *infra*.

negligible impact in one case and a draconian effect in another. Factors to be considered include the nature of the penalty,[6] whether the penalty is to be paid from the estate of an individual, a partnership, or a corporation, the amount of the penalty relative to the amount of other allowed claims, and the nature of the bankruptcy relief sought by the debtor.[7] Neither the Bankruptcy

6. The distinction between compensatory pecuniary loss penalties and punitive nonpecuniary loss penalties has been recognized by Congress under the former Bankruptcy Act, *see* section 57(j), 11 U.S.C. § 93(j) (repealed), as well as under the Bankruptcy Code, *see* 11 U.S.C. § 507(a)(7)(G), 11 U.S.C. § 726(a)(4). The unfairness of allowing payment to the IRS on account of its punitive tax penalties when other creditors have not been paid for their pecuniary losses has been considered by the courts of appeals in determining that governmental misconduct was not required in order to permit the subordination of nonpecuniary loss tax penalty claims. *See Virtual Network Services*, 902 F.2d at 1250; *Schultz Broadway Inn*, 912 F.2d at 234; *First Truck Lines*, 48 F.3d at 218-19 (Pet. App. 20a); *CF & I*, 53 F.3d at 1159.

7. Thus, because the consequences would be very similar to a proceeding under chapter 7, the Eighth Circuit Court of Appeals subordinated a nonpecuniary loss tax penalty against a corporate debtor in a liquidating chapter 11 case in order to protect ordinary creditors from the debtor's punitive obligations. However, that court also recognized that a different result might be appropriate if a debtor reorganized under chapter 11 and ultimately returned to a viable and profitable economic state. *Schultz Broadway Inn*, 912 F.2d at 233.

In the present case, FTL did not ultimately return to a viable and profitable economic state, and the consequences in this converted case are very similar to those in a proceeding commenced under chapter 7. A reorganized debtor is in many respects similar to a prepetition debtor because the confirmation of a chapter 11 plan generally vests all of the property of the estate in the debtor. 11 U.S.C. § 1141(b). Because the property of the estate had revested in FTL, the conversion of FTL's case to chapter 7 was tantamount to the filing of a new petition. Therefore, although the penalties at issue arose postpetition, to the extent that those penalties also arose after confirmation of FTL's chapter 11 plan due to the failure of FTL to pay postconfirmation taxes,

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Code, the common law, nor the legislative history to 11 U.S.C. § 510(c) include a misconduct requirement as a prerequisite to the subordination of punitive nonpecuniary loss tax penalties in an appropriate case. The decision of the court of appeals should therefore be affirmed.

B. Other Provisions of the Bankruptcy Code Support the Subordination of Punitive Nonpecuniary Loss Tax Penalty Claims.

1. Section 57(j) of the former Bankruptcy Act, 11 U.S.C. § 93(j)(repealed),[8] "plainly manifest[ed] a congressional purpose to bar all claims of any kind against a bankrupt except those based on a 'pecuniary' loss. . . . [T]he prohibition of all tax penalties in bankruptcy is wholly consistent with the policy of the penalty provisions themselves. Tax penalties are imposed at least in part as punitive measures against persons who have been guilty of some default or wrong. Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors" (Footnote omitted). *Simonson v. Granquist*, 369 U.S. 38, 40-41 (1962). When the Bankruptcy Code was enacted, it made significant changes in both the substantive and procedural law of bankruptcy. *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 53 (1982). One of

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see Appendix B, *infra* at 9a, the Congressional intent to subordinate prepetition nonpecuniary loss tax penalties in chapter 7 cases, *see* 11 U.S.C. § 726(a)(4), should be equally applicable here.

8. Section 57(j) provides in pertinent part that "[d]ebts owing to the United States or any State or subdivision thereof as a penalty or forfeiture shall not be allowed, *except for the amount of the pecuniary loss sustained by the act, transactions, or proceeding out of which the penalty or forfeiture arose* . . ." (Emphasis added).

those many changes is the statutory allowance of nonpecuniary loss tax penalty claims in bankruptcy cases;[9] another is the codification of the doctrine of equitable subordination in 11 U.S.C. § 510(c).

Because the Bankruptcy Code substantially overhauled the bankruptcy system, "it is not appropriate or realistic to expect Congress to have explained with particularity each step it took, rather, as long as the statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute." *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 240-41 (1989). The statutory scheme of the Bankruptcy Code is coherent and consistent and supports subordination of nonpecuniary loss tax penalty claims.

The punitive nonpecuniary loss tax penalty claims at issue in this case are administrative expenses pursuant to 11 U.S.C. § 503(b)(Pet. App. 3a). Pursuant to 11 U.S.C. § 726(a)[*see* note 2, *supra*], the provisions of 11 U.S.C. § 510 apply to administrative expenses allowed pursuant to 11 U.S.C. § 503(b). The appellate court applied section 510(c)(1) as expressly permitted by section 726(a) to weigh the equities of the nonpecuniary loss tax penalty claims of the IRS against other allowed claims. An examination of the remainder of the Bankruptcy Code establishes that no misconduct is required prior to the application of the principles of equitable subordination to the nonpecuniary loss tax penalty claims of the IRS in this case.

> Statutory construction ... is a holistic endeavor. A provision that may seem

9. The allowance of claims generally is controlled by 11 U.S.C. § 502. The allowance of administrative expense penalty claims is controlled by 11 U.S.C. § 503(b)(1)(C) [*see* note 10, *infra*].

> ambiguous in isolation is often clarified by the remainder of the statutory scheme — because the same terminology is used elsewhere in a context that makes its meaning clear ... or because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law.

(Citations omitted). *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 371 (1988).

Although the Bankruptcy Code fails to expressly distinguish between postpetition pecuniary loss and postpetition nonpecuniary loss tax penalty claims, 11 U.S.C. § 503(b)(1)(C),[10] the Bankruptcy Code elsewhere repeatedly

10. Sections 503(b)(1)(B) and (C) provide in pertinent part:

> (b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including —
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> • • •
>
> (B) any tax —
>
> (i) incurred by the estate, except a tax of a kind specified in section 507(a)(7) of this title ...
>
> • • •
>
> (C) any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph.

distinguishes between pecuniary loss tax penalty claims and nonpecuniary loss tax penalty claims, and invariably subordinates the punitive nonpecuniary loss tax penalties to the compensatory pecuniary loss tax penalties. *See* 11 U.S.C. § 507(a)(7)(G);[11] 11 U.S.C. § 726(a)(4).[12] This is consistent with the bankruptcy policy of favoring pecuniary loss claims over nonpecuniary loss claims. *See Simonson v. Granquist*, 369 U.S. at 40-42 (1962).

By consistently ignoring the plain language of the statutory sections of the Bankruptcy Code which it cites, the IRS seeks to cloak its nonpecuniary loss tax penalties, which have

11. Section 507(a)(7) provides in pertinent part:

> (a) The following expenses and claims have priority in the following order:
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> • • •
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> (7) Seventh, allowed unsecured claims of governmental units, only to the extent that such claims are for —
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> • • •
>
> (G) a penalty related to a claim of a kind specified in this paragraph *and in compensation for actual pecuniary loss*. (Emphasis added).

12. Moreover, the Bankruptcy Code envisions that claims that are substantially similar to one another be classified together and receive the same treatment. *See* 11 U.S.C. § 1122(a); 11 U.S.C. § 1222(a)(3); 11 U.S.C. § 1322(a)(3). It follows that claims such as punitive nonpecuniary loss tax penalty claims, which are not substantially similar to compensatory pecuniary loss tax penalty claims, may receive different treatment that that accorded to compensatory pecuniary loss tax penalty claims.

traditionally been disfavored, *see Simonson*, *supra*, with the preferred status of compensatory pecuniary loss penalties. Petitioner is wrong when it states that "[s]ection 726(a)(4) expressly subordinates prepetition tax penalties to general unsecured claims." Brief at 19 n.6; *see also* Brief at 22-23 ("Section 726 provides first priority for claims for *post*petition tax penalties but subordinates claims for *pre*petition penalties to general unsecured claims.") To the contrary, 11 U.S.C. § 726(a)(4) only subordinates penalties "to the extent that such . . . penalt[ies] . . . are not compensation for actual pecuniary loss suffered by the holder of such claim." Compensatory penalties are not subordinated; they receive the same status as other general unsecured claims in chapter 7 cases. Petitioner is also wrong when it states that "[i]n cases outside of Chapter 7, prepetition tax penalties are paid on a parity with general unsecured claims." Brief at 20 n. 6. Pursuant to 11 U.S.C. § 507(a)(7)(G), a penalty which is "in compensation for actual pecuniary loss" and related to an allowed unsecured priority claim of a governmental unit is itself entitled to priority over general unsecured claims, rather than treated on a parity with general unsecured claims.[13] It is only the nonpecuniary loss penalty claims which are paid on a parity with general unsecured claims outside of Chapter 7.[14]

13. Section 507(a)(7)(G) of the Bankruptcy Code applies not only to Chapter 11, 12 and 13, it also applies to Chapter 7 cases. 11 U.S.C. § 103(a); *see also* 11 U.S.C. § 726(a)(1). By its terms, 11 U.S.C. § 726(a)(4) applies to nonpecuniary loss penalty claims in a chapter 7 case arising before the earlier of the order for relief or the appointment of a trustee.

14. The payment of nonpecuniary loss penalty claims on a parity with general unsecured claims in chapter 11 cases creates a potential problem due to the requirement that a chapter 11 plan meet the best interest of creditors test in order to be confirmed. The best interest of creditors test, codified in 11 U.S.C. § 1129(a)(7), is an integral part of the confirmation requirements for chapter 11 plans. The test requires that creditors receive no less in a chapter 11 distribution than they would receive if the debtor were liquidated in a case under chapter 7 as of the effective date of the plan.

(Cont'd)

2. In addition to the statutory allowance of postpetition taxes and penalties as administrative expenses, 11 U.S.C. § 503(b)(1)(B), (C) [*see* note 10, *supra*], Congress has also given bankruptcy courts very broad powers to allow claims as administrative expenses when a trustee or debtor in possession[15] operates the business of the debtor. 11 U.S.C. § 364.[16] Congress

(Cont'd)

If prepetition nonpecuniary loss tax penalty claims were automatically subordinated in a chapter 7 case but were precluded from being subordinated in a chapter 11 case because the claimant had not engaged in inequitable conduct, the debtor's chapter 11 plan could not be confirmed and the bankruptcy policy of promoting reorganization would be thwarted. Even if a liquidating chapter 11 plan were proposed, it could not be confirmed if misconduct were a prerequisite to equitable subordination of the nonpecuniary loss tax penalty claims. It would be absurd to require conversion to chapter 7, with its attendant administrative expenses, in order to obtain the statutory right to subordinate the nonpecuniary loss tax penalties in a liquidation when the same result could be achieved by applying the principles of equitable subordination contained in 11 U.S.C. § 510(c). *In re Cassis Bistro, Inc.*, 188 Bankr. 472, 475 (Bankr. S.D.Fl. 1995). The operation of the best interest of creditors test is illustrated by the hypothetical printed in Appendix C.

15. Pursuant to 11 U.S.C. § 1101(1), "debtor in possession" means debtor in a chapter 11 case unless a person that has qualified under 11 U.S.C. § 322 is serving as trustee in the case. A debtor in possession generally has the same rights and powers as a trustee serving in a chapter 11 case, including the right and power to operate a debtor's business. 11 U.S.C. §§ 1107, 1108.

16. Section 364 of the Bankruptcy Code provides in pertinent part:

> (a) If the trustee is authorized to operate the business of the debtor under section 721, 1108, 1203, 1204, or 1304 of this title, unless the court orders otherwise, the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense.

(Cont'd)

recognized the paramount importance[17] of extending credit to

(Cont'd)

> (b) The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense.
>
> (c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt —
>
> (1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;
>
> (2) secured by a lien on property of the estate that is not otherwise subject to a lien; or
>
> (3) secured by a junior lien on property of the estate that is subject to a lien.
>
> • • •
>
> (e) The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.

17. The high priority placed on postpetition financing is evident in light of the extraordinary protections given to any party which extended credit from an adverse ruling on appeal of the order authorizing the trustee or debtor in possession to obtain credit. *See* 11 U.S.C. § 364(e), note 16, *supra*.

help a trustee or debtor in possession operate a business and expressly gave the bankruptcy courts authority to elevate these claims of creditors who give value to a superpriority status over allowed administrative expense claims. 11 U.S.C. § 364(c). The subordination of postpetition nonpecuniary loss tax penalty claims is entirely consistent with this statutory scheme which elevates the postpetition claims of parties, which give value so that the business of a debtor can operate, over other administrative expense claims.

Subordination of postpetition nonpecuniary loss tax penalty claims should also be favored as a practical matter. If postpetition nonpecuniary loss tax penalty claims are not subject to being subordinated without a finding of inequitable conduct by the claimant, any party doing business or extending credit postpetition to a trustee or debtor in possession will insist on superpriority status before providing goods or services. The bankruptcy estate and the provider of goods or services will incur increased expenses in order to protect the provider of goods or services. Delays will arise due to the need to work out the terms of the agreement and to obtain court approval of the superpriority status. These delays could be fatal to a business dependent on the delivery of the goods or services for its continued operation. If subordination of nonpecuniary loss tax penalties is not available, the attendant increase in costs and delays will both be contrary to the strong bankruptcy policy in favor of rehabilitating or reorganizing debtors.

Although 11 U.S.C. § 364 could be used in future cases to achieve the result achieved below in this case, it should not be necessary to engage in that tortuous and expensive process because application of the principles of equitable subordination permits the subordination of postpetition punitive nonpecuniary loss tax penalty claims in appropriate cases.

The distinction between pecuniary and nonpecuniary loss

claims, the preferred status of parties who provide value to permit a trustee or debtor in possession to operate postpetition, and the disfavored status of punitive nonpecuniary loss penalties inexorably lead to the conclusion that, in a chapter 7 case where the corporate debtor has ceased to operate, entirely innocent claimants who suffered actual pecuniary losses should not bear the additional burden of the nonpecuniary loss tax penalty claims of the IRS which arose from the failure of the debtor to pay certain taxes arising from its operation after the debtor filed its chapter 11 petition but before its case was converted to chapter 7. By codifying the doctrine of equitable subordination at the same time as allowing penalty claims, Congress provided a necessary counterbalance in appropriate cases such as this to assure that the remedial subordination provisions of 11 U.S.C. § 510(c)(1) are available to protect entirely innocent claimants who gave value from the detrimental impact of misguided nonpecuniary loss tax penalty claims.

C. Subordination of Punitive Nonpecuniary Loss Tax Penalty Claims Is Consistent with Prior Decisions of This Court.

1. This Court has never decided whether nonpecuniary loss tax penalty claims can be equitably subordinated. Neither *Boteler v. Ingels*, 308 U.S. 57 (1939) nor *Nicholas v. United States*, 384 U.S. 678 (1966) address that issue. Both *Boteler* and *Nicholas* found that postpetition penalties incurred by the bankruptcy trustee could be allowed as administrative expense claims. Equitable subordination was not at issue.

In *Boteler*, the Court sustained a penalty against a trustee in bankruptcy who failed to pay state license fees while operating the business of the bankrupt estate for purposes of liquidation. 308 U.S. at 61. In *Nicholas*, the trustee failed to timely file returns for the taxes incurred by a debtor in possession during the Chapter XI arrangement proceeding. 384 U.S. at 695. The Court found that "[n]o legitimate interest would be served by

permitting the trustee to escape the unburdensome responsibility of merely filing the returns and thereby notifying the United States of the taxes that are due." *Id.* Furthermore, the payment of penalties due to the trustee's failure to file tax returns did not involve any major inequities between creditors of the same class. 384 U.S. at 693 n. 27. Neither *Boteler* nor *Nicholas* concerned the subordination of claims. Instead, they merely stand for the proposition that postpetition penalty claims are allowed claims within the category of claims known as administrative expense claims.[18]

2. The decisions of this Court which do address the application of the doctrine of equitable subordination of allowed claims involve pecuniary loss claims of a dominant entity in a position of control which can improve its position to the detriment of other claimants in the case.

As initially formulated, the doctrine of equitable subordination was virtually unlimited. "The power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete." *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941) (Citing *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307 (1939) and *Pepper v. Litton*, 308 U.S. 295 (1939)).

18. Other cases which involve the allowance of administrative claims, rather than the subordination of allowed claims, are similarly distinguishable. *See New Jersey v. Anderson*, 203 U.S. 483, 494 (1906) (alleged tax was a true tax entitled to priority in payment pursuant to section 64a of the former Bankruptcy Act (repealed)); *In re Samuel Chapman, Inc.*, 394 F.2d 340, 341 (2d Cir. 1968), *cert. denied*, 393 U.S. 923 (1968); *United States Department of Interior v. Elliott*, 761 F.2d 168, 170 (4th Cir. 1985). The allowance of postpetition tax or penalty claims as determined by these cases has been codified in 11 U.S.C. § 503(b)(1) [*see* note 10, *supra*]. These cases do not reach the subordination issue. Whether allowed postpetition nonpecuniary loss tax penalty claims may be subordinated pursuant to 11 U.S.C. § 510(c)(1) is the issue before this Court.

In *Taylor*, practically all of the common stock of the debtor, Deep Rock Oil Corporation, was owned by Standard Gas & Electric Co., which was claiming as a creditor. 306 U.S. at 309. Standard exercised complete control and domination over Deep Rock, often to the detriment of Deep Rock. 306 U.S. at 320, 323. The Court found that Deep Rock was bankrupt not only because it owed Standard enormous sums but because Standard abused its role in management due to the paramount interest of the interlocking officers and directors to preserve Standard's position as both proprietor and creditor of Deep Rock. 306 U.S. at 323. Under these circumstances, the Court applied broad equitable principles and declined to observe the doctrine of corporate entity because it would work fraud *or* injustice on the preferred shareholders. 306 U.S. at 322. Standard's claim was therefore subordinated to that of the injured preferred shareholders. 306 U.S. at 324.

Approximately nine months later, the Court in *Pepper v. Litton*, 308 U.S. 295 (1939), observed that the subordination in *Taylor* "was based on the equities of the case - the history of spoliation, mismanagement, and faithless stewardship of the subsidiary by Standard to the detriment of the public investors." 308 U.S. at 308. In *Pepper*, the Court considered the disallowance or subordination of the salary claim of a dominant and controlling shareholder relative to the claims of other creditors. The Court noted that bankruptcy courts are essentially courts of equity, and that their equitable powers had often "been invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." 308 U.S. at 305. The Court recognized that the disallowance or subordination of claims may be necessitated by certain cardinal principles of equity jurisprudence. 308 U.S. at 306. "In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift

the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate." (Footnote omitted). 308 U.S. at 307-08. Although misconduct or fraud is evident in *Pepper*, the Court's sweeping statements that the bankruptcy court may exercise its equitable jurisdiction to prevent injustice or unfairness in the administration of a bankruptcy estate suggest that misconduct is not required if there is either injustice or unfairness as contemplated by the *Taylor* or *Pepper* decisions.

The third decision of this Court addressing equitable subordination, *Comstock v. Group of Institutional Investors*, 335 U.S. 211 (1948), also arose under the former Bankruptcy Act and applied the teachings of *Taylor* and *Pepper* to another dominant shareholder situation. Once again, a pecuniary loss claim was involved. Although there was domination of the subsidiary, Justice Jackson, speaking for the five Justice majority, delivered the opinion of the Court and stated that "[i]t is not mere existence of an opportunity to do wrong that brings the rule [equitable subordination] into play; it is the unconscionable use of the opportunity afforded by the domination to advantage itself at the injury of the subsidiary that deprives the wrongdoer of the fruits of his wrong." 335 U.S. at 229. Subordination was therefore denied. In criticizing the majority decision, the four dissenting Justices pointed out that "[t]he equities which form the Deep Rock doctrine relate not alone to matters of bad faith. They are also concerned with the essential fairness and propriety of transactions from an objective standpoint. *Pepper v. Litton*, [308 U.S. at] 306." *Comstock*, 335 U.S. at 237-38 (Murphy, J., dissenting).

Taylor, *Pepper*, and *Comstock*, each *supra*, share the common thread that subordination may be proper against dominant shareholders who have suffered pecuniary losses but

engage in misconduct or breach their fiduciary duties to other creditors. The application of the principles of equitable subordination to nonpecuniary loss tax penalty claims does not require any departure from that general rule because the nonpecuniary loss tax penalty claims are punitive rather than compensatory, and are thus by their very nature disfavored and susceptible to subordination.[19] Such a result is consistent with both the former and current bankruptcy laws, with prior decisions of this Court, and with the legislative history to 11 U.S.C. § 510.

D. The Legislative History Accompanying 11 U.S.C. § 510(c) Supports the Subordination of Punitive Nonpecuniary Loss Tax Penalty Claims.

The Bankruptcy Act of 1898, as amended (repealed), contained no provision concerning the equitable subordination of claims analogous to 11 U.S.C. § 510(c)(1). Many proposals were considered with respect to the subordination of claims before Congress settled on the text of 11 U.S.C. § 510. One proposal suggested the subordination of "any claim, whether secured or unsecured, to the extent it is for a fine, penalty, or forfeiture or for multiple, punitive, or exemplary damages." *Report of the Commission on the Bankruptcy Laws of the United States*, H.R. Doc. No. 137, 93d Cong., 1st Sess. Pt. II, at 115, § 4-406(a)(3) (1973). That proposed statute did not distinguish between pecuniary and nonpecuniary loss penalties, but did

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19. Other subordination decisions that pre-date the enactment of the Bankruptcy Code which the IRS cites in support of its position that misconduct is a required prerequisite to subordination are similarly distinguishable on the basis that the dispute involved the subordination of pecuniary loss claims. *See, i.e., Benjamin v. Diamond*, 563 F.2d 692, 695 (5th Cir. 1977) (pecuniary loss claims based upon debentures); *Stebbins v. Crocker Citizens Nat'l Bank*, 516 F.2d 784, 786 (9th Cir. 1975) (pecuniary loss claims based on promissory notes).

clearly state that the equitable power of a bankruptcy court to subordinate claims was not limited.[20]

The legislative history which accompanies 11 U.S.C. § 510 provides in pertinent part:

> Section 510 (c)(1) of the House amendment represents a compromise

---

20. Proposed section 4-406, entitled Subordination of Claims, provided in pertinent part:

> (a) *Subordinated Classes of Claims*. The following claims are subordinated in payment to all other nonsubordinated but allowable claims:
>
> • • •
>
> (3) any claim, whether secured or unsecured, to the extent it is for a fine, penalty, or forfeiture or for multiple, punitive, or exemplary damages.
>
> • • •
>
> (c) *Equitable Power of Court to Subordinate Other Claims*. This section does not limit the equitable power of a bankruptcy court to subordinate claims or to enforce voluntary subordination agreements.

Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93d Cong., 1st Sess. Pt. II, at 115, § 4-406 (1973).

Given the express authorization in 11 U.S.C. § 510(c) to subordinate all or part of an allowed claim to all or part of another allowed claim, the failure to retain a provision expressly subordinating penalties does not mean that penalties may not be subordinated under section 510(c); to the contrary, it means only that the subordination is not automatic.

> between similar provisions in the House bill and Senate amendment. After notice and a hearing, the court may, under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest. As a matter of equity, it is reasonable that a court subordinate claims to claims and interests to interests. It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if holder of such claim is guilty of inequitable conduct, or the claim itself is of a status susceptible to subordination, such as a penalty or a claim for damages arising from the purchase or sale of a security of the debtor.

124 Cong. Rec. H11,089, H11,095 (Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. S17,406, S17,412 (Oct. 6, 1978) (statement of Sen. DeConcini).

This quotation from the sponsors[21] of the Bankruptcy Reform Act demonstrates that "Congress contemplated that section 510(c)(1) would be used to subordinate claims involving *either* inequitable conduct *or* claims such as penalties that were

---

21. In the absence of a conference and in light of the key roles playes by the Senate and House floor managers, Senator DeConcini and Representative Edwards, their floor statements on the Bankruptcy Code may be treated as persuasive evidence of Congressional intent. *Begier v. Internal Revenue Service*, 496 U.S. 53, 64 n.5 (1990).

of a 'status susceptible to subordination.' " *Schultz Broadway Inn v. United States*, 912 F.2d 230, 233 (8th Cir. 1990). The preceding legislative history contains the following key elements:

> 1. The "principles of equitable subordination" are to follow then-existing case law.
>
> 2. Claims were generally subordinated if:
>
> a. the holder of the claim was guilty of inequitable conduct;
>
> b. the claim itself was of a status susceptible to subordination, such as a penalty, regardless of the claimant's conduct; or
>
> c. the claim itself was of a status susceptible to subordination, such as a claim for damages arising from the purchase or sale of a security of the debtor, regardless of the claimant's conduct.
>
> 3. Development of the principles of equitable subordination was left to the courts.

Since the IRS asserts that as of 1978, no court had held that a tax penalty or any other kind of penalty claims were subject to equitable subordination, Brief at 21, it is not surprising that the IRS repeatedly turns to additional legislative history in a futile attempt to prove that its nonpecuniary loss tax penalties are not

subject to equitable subordination. Brief at 17 n. 4, 22. The unabridged provisions from which the IRS quotes state:

> Subsection (b)[now moved to subsection c] authorizes the bankruptcy court, in ordering distribution of assets, to subordinate all or any part of any claim to all or any part of another claim, *regardless of the priority ranking of either claim*. In addition, any lien securing such a subordinated claim may be transferred to the estate. The bill provides, however, that any subordination ordered under this provision must be based on principles of equitable subordination. These principles are defined by case law, and have generally indicated that a claim may normally be subordinated only if its holder is guilty of misconduct. As originally introduced, the bill provided specifically that a tax claim may not be subordinated on equitable grounds. The bill deletes this express exception, but the effect under the amendment should be much the same in most situations since, under the judicial doctrine of equitable subordination, a tax claim would rarely be subordinated.

(Emphasis added). S. Rep. No. 95-989, 95th Cong., 2d Sess. 74 (1978). The IRS also relies on legislative history which provides:

> Since the House amendment authorizes subordination of claims only under principles of equitable subordination, and thus incorporates principles of existing case

law, a tax claim would rarely be subordinated under this provision of the bill.

124 Cong. Rec. H11,113 (Sept. 28, 1978); 124 Cong. Rec. S17,430 (Oct. 6, 1978).

Neither passage rescues the IRS. Not only was the exclusion of tax claims from the operation of the equitable subordination statute eliminated, the priority ranking of any claim did not affect whether it could be subordinated to any other claim. If Congress deemed it appropriate to make compensatory tax claims subject to the equitable subordination provisions of 11 U.S.C. § 510(c)(1), regardless of their priority rankings, the subordination provisions of the statute easily encompass disfavored nonpecuniary loss tax penalties.

The statement in the legislative history that "a tax claim would rarely be subordinated" also fails to aid the IRS. Tax claims are compensatory; nonpecuniary loss tax penalty claims are punitive. It is indisputable that the penalty provisions in the tax code are expressly meant to deter and punish, "two goals in contravention of any equity or equitable considerations." *In re Virtual Network Services Corp.*, 902 F.2d 1246, 1249 (7th Cir. 1990). This Court has long recognized that "[t]ax penalties are imposed at least in part as punitive measures against persons who have been guilty of some default or wrong. Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors." (Footnote omitted) *Simonson v. Granquist*, 369 U.S. 38, 40-41 (1962). The dissenting Justices in *Simonson* also agreed with that proposition. "I also agree that § 57j, 11 USC § 93(j), denying claims for penalties against the estate, reflects a policy against disadvantaging innocent creditors for the wrongs of the bankrupt." 369 U.S. at 42 (Frankfurter, J., dissenting).

The Congressional intent is clear. The subordination for purposes of distribution of all or part of an allowed claim to all or part of another allowed claim, regardless of the priority ranking of either claim, is expressly permitted by 11 U.S.C. § 510(c)(1). Punitive nonpecuniary loss tax penalties are of a disfavored status susceptible to subordination. Compensatory tax penalties are not of a disfavored status, and will rarely be subordinated. The development of the principles of equitable subordination has been left to the courts, and this Court should interpret 11 U.S.C. § 510(c)(1) to conform with bankruptcy policy and to carry out Congressional intent. Because the lower courts properly balanced the equities of the postpetition punitive nonpecuniary loss tax penalty claims of the IRS against the claims of creditors who gave actual value, subordination of the postpetition punitive nonpecuniary loss tax penalty claims of the IRS was proper in this case, and the Court should affirm the decision of the court of appeals.

has been left to the courts and this Court should interpret 11 U.S.C. § 510(c)(1) to conform with bankruptcy policy and to carry out congressional intent. Because the lower courts properly balanced the equities of the postpetition punitive nonpecuniary loss tax penalty claims of the IRS against the claims of creditors who gave actual value, subordination of the postpetition punitive nonpecuniary loss tax penalty claims of the IRS was proper in this case, and the Court should affirm the decision of the court of appeals.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

RAYMOND J. PIKNA, JR.
Counsel of Record
THOMAS R. NOLAND
ROBERT B. BERNER
GREGORY P. GARNER
ALTICK & CORWIN CO., L.P.A.
Attorneys for Respondent
1700 One Dayton Centre
One South Main Street
Dayton, Ohio 45402
(513) 223-1201

APPENDIX A — HYPOTHETICAL CHAPTER 11 DISTRIBUTION ANALYSIS

Assumptions:

1. All claims are administrative expense claims.

2. The sum of $315,000 is available to pay administrative expense claims which total $360,000.

3. The following administrative expense claims are allowed:

A. IRS pecuniary loss claim for taxes	$90,000
IRS pecuniary loss claim for interest	$45,000
IRS *nonpecuniary* loss claim for penalty	$45,000
Total IRS claims	$180,000
B. Trade (*i.e.* supplies, utilities, etc.)	
Principal amount of pecuniary loss claim	$90,000
Accrued interest pecuniary loss claim	$45,000
Total trade claims	$135,000
C. Professional fees (*i.e.* attorneys, accountants, etc.)	
Principal amount of pecuniary loss claim	$45,000
Total claims for professional fees	$45,000

Appendix A

Summary of claims:

Pecuniary loss claims

IRS - tax	$ 90,000
IRS - interest	$ 45,000
Trade - principal	$ 90,000
Trade - interest	$ 45,000
Professional - principal	$ 45,000
Total pecuniary loss claims	$315,000

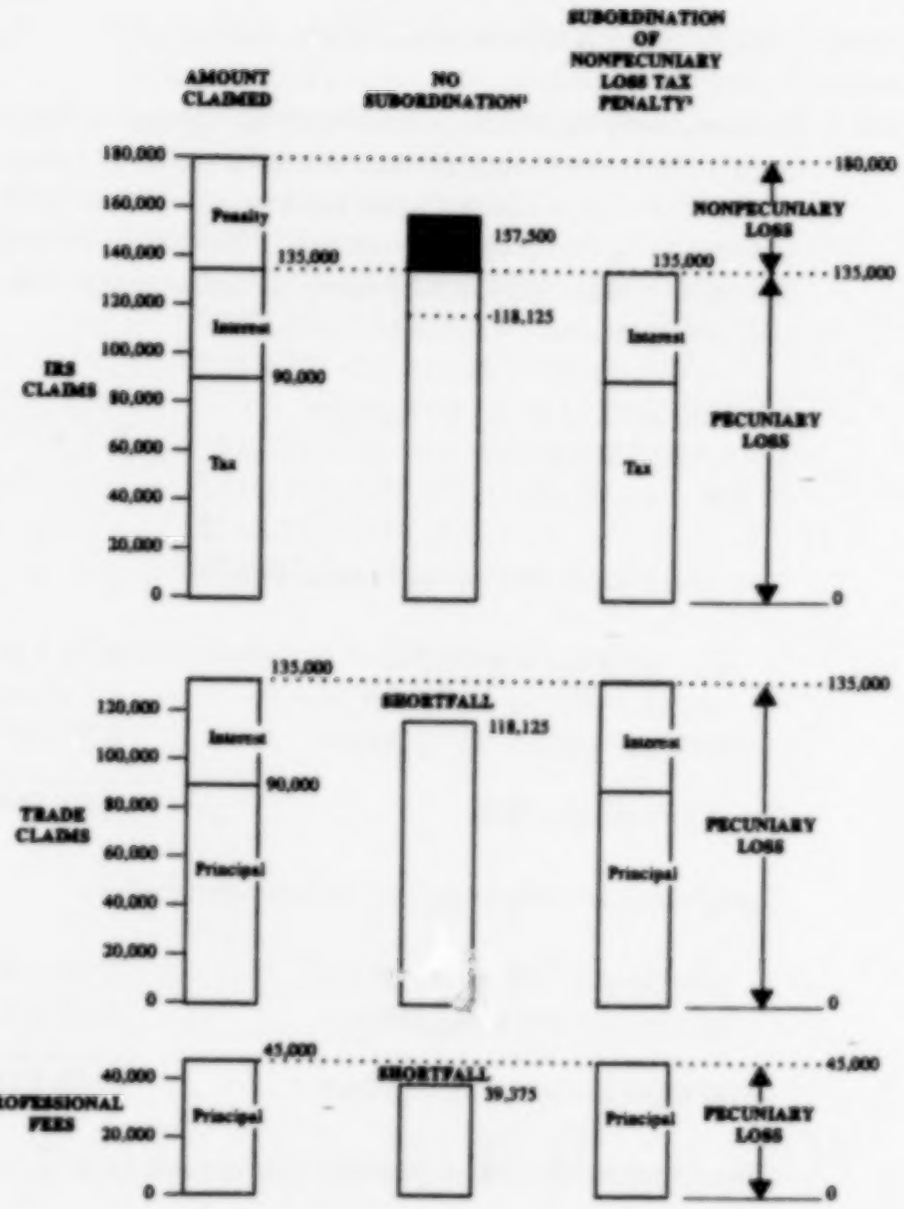
Nonpecuniary loss claims

IRS - penalty	$ 45,000
Total nonpecuniary loss claims	$ 45,000

Total claims

Pecuniary loss	$315,000
Nonpecuniary loss	$ 45,000
Total claims	$360,000

Appendix A



Appendix A

1. NO EQUITABLE SUBORDINATION

If there is no equitable subordination, the percentage distributed on account of each administrative expense claim is computed based upon the amount of available funds ($315,000) divided by the total amount of allowed pecuniary loss ($315,000) *and* nonpecuniary loss ($45,000) claims:

$315,000/($315,000 + $45,000) =
$315,000/$360,000 =
87.5%

Computation of amount payable to IRS:

tax: 87.5% x $90,000 =	$ 78,750
interest: 87.5% x $45,000 =	$ 39,375
penalty: 87.5% + $45,000 =	$ 39,375
Total payable to IRS	**$157,500**

Computation of amount payable to trade vendors:

principal 87.5% x $90,000 =	$ 78,750
interest 87.5% x $45,000 =	$ 39,375
Total payable to trade vendors	**$118,125**

Computation of amount payable to professionals:

principal 87.5% x $45,000 =	$ 39,375
Total payable to professionals	**$ 39,375**

Appendix A

The amount paid to a claimant as a percentage of the pecuniary loss claims is determined by dividing the total amount paid to that claimant by the total amount of that claimant's pecuniary loss claims.

IRS: $157,500/(tax + interest) =
$157,500/($90,000 + $45,000) =
$157,500/$135,000 =
116.67% of pecuniary loss claims

Trade: $118,125/(principal + interest) =
$118,125/($90,000 + $45,000) =
$118,125/$135,000 =
87.5% of pecuniary loss claims

Professional: $39,375/(principal) =
$39,375/($45,000) =
87.5% of pecuniary loss claims

Appendix A

2. SUBORDINATION OF NONPECUNIARY LOSS TAX PENALTY CLAIMS

If the nonpecuniary loss tax penalty claims are equitably subordinated, the percentage distributed on account of pecuniary loss claims is computed based upon the total amount of available funds divided by the amount of allowed pecuniary loss claims.

$315,000/(total pecuniary loss tax claims + total trade claims + total professional fees)
$315,000/[($90,000 + $45,000) + ($90,000 + $45,000) + $45,000] =
$315,000/$315,000 =
100%

The subordination of the nonpecuniary loss tax penalty claims of the IRS pursuant to 11 U.S.C. § 510(c)(1) permits all pecuniary loss claims, which by their nature are similar, to receive similar treatment.

APPENDIX B — REQUEST FOR PAYMENT OF INTERNAL REVENUE TAXES (PROOF OF CLAIM #102) WITH ATTACHED LETTER FILED NOVEMBER 22, 1988

REQUEST FOR PAYMENT OF INTERNAL REVENUE TAXES

(Bankruptcy Code Cases — Administrative Expenses)

Department of the Treasury/Internal Revenue Service

United States Bankruptcy Court for the Southern District of OH

In the Matter of:

FIRST TRUCK LINES, INC
1500 FARR DR
DAYTON OH 45404

Fiduciary:

Case Number
38600925

Type of Bankruptcy Case
Chap. 7

Date of Petition
04/10/86

Taxpayer Identifying Number
Social Security Number
Employer Identification Number
illegible

Appendix B

1. The undersigned, whose business address is *P.O. Box 1579, CINCINNATI, OH 45201,* is the agent of the Department of Treasury, Internal Revenue Service, and is authorized to make this request for payment on behalf of the United States.

2. Request is made for payment of taxes and any interest or penalty due under the internal revenue laws of the United States, as shown below.

3. The ground of liability is taxes due under the internal revenue laws of the United States.

Appendix B

Administrative Claims

Kind of Tax	*Tax Period*	*Tax Due*	*Accrued Interest as of 10 Days from the Date of this Request*	*Accrued Penalty as of 10 Days from the Date of this Request*	*Balance Due*
FUTA	12/31/87	3,055.66	478.62	175.18	3,709.46
FUTA	12/31/88	1,750.00	.00	.00	1,750.00
WT-FICA	09/30/87	16,423.86	3,029.20	8,586.02	28,039.08
WT-FICA	03/31/88	21,075.52	2,698.49	589.80	24,363.81
WT-FICA	06/30/88	24,862.92	4,848.18	7.40	29,718.50
CORP-INC	12/31/87	300.00	.00	.00	300.00

Appendix B

* ESTIMATED TAX CLAIMS HAVE BEEN FILED BECAUSE THE DEBTOR HAS FAILED TO FILE THE RETURN(S) FOR THE ESTIMATED PERIODS. AS SOON AS THE DEBTOR FILES THE RETURN(S) WITH THE I.R.S. AS REQUIRED BY LAW, THIS CLAIM WILL BE ADJUSTED AS NECESSARY.

Amount due as of 10 days from date of this request $87,880.85

Compound interest will accrue at the rate established under IRC Section 6621(b). Contact Chief, Special Procedures function at *see below* for balance due if paid after *11/28/88*. Dollar amount per month at which late payment penalty will be charged (at 1/2 of 1 percent a month) after 10 days from the date of this request $67,467.96

Penalty for Presenting Fraudulent Claim — Fine of not more than $5,000 or Imprisonment for not more than 5 years or both — Title 18, U.S.C., Section 152.

Signature
s/ Marilyn J. Hicks

Title
Manager, Procedures & Insolvency Unit

Date
11/18/88

Telephone Number
(513) 684-2442

Appendix B

INTERNAL REVENUE SERVICE
District Director

Department of the Treasury
P.O. Box 1579
ROOM 3511
CINCINNATI, OH 45201

Date: 11/18/88

Person to Contact:
T. ROBERTS

Contact Telephone Number:
(513) 684-2442

FIRST TRUCK LINES, INC

1500 FARR DR
DAYTON OH 45404

Refer Reply to:
C:S

Docket No. 38600925

We understand you are presently involved in a Chapter 7A Bankruptcy proceeding. Bankruptcy Code Section 507 gives priority claim status to unpaid taxes due the United States of America.

We have no record of receiving the Federal tax returns listed on page 2 of this letter. If you have filed, or if you are not required to file these returns, please provide the information requested.

If you are required to file, attach the returns to this letter and send them to us at the address shown above within 10 days from the date of this letter.

Appendix B

If we do not receive your response and/or delinquent returns within 10 days, we are compelled to proceed with appropriate legal action within the framework of both the Internal Revenue Code and the Bankruptcy Code.

Sincerely,

s/ Gary A. Blomberg
Gary A. Blomberg
Chief, Special Procedures Staff

cc: United States Bankruptcy Court BSDDA
Debtor's Attorney ------ PETER J. DONAHUE, ESQ.
P.O. BOX 1817

DAYTON, OH 45401-1817
Trustee ---------- THOMAS R. NOLAND
900 TALBOTT TOWER

DAYTON, OH 45402-1104

If you have filed the returns listed, please give us the name, address, Employer Identification Number or Social Security Number, date filed, and the amount paid with each. If you have a cancelled check that accompanied the return(s), please provide a copy of the front and back of the check.

If you are not required to file the return(s), please give us the reason and the date on which you were no longer liable.

Appendix B

Form #	Period Ended	Status
940	12/31/88 :	
1120	12/31/87 :	

Signature : _____

Title : _____

TEL # : _____

APPENDIX C — BEST INTEREST OF CREDITORS TEST HYPOTHETICAL [11 U.S.C. § 1129(a)(7)]

Assumptions:

1. Debtor seeks confirmation of its chapter 11 plan.

2. Debtor employs 500 people.

3. After payment of administrative expense and priority claims, $1,000,000 remains in the estate for distribution to unsecured creditors.

4. Pre-petition unsecured claims:

Nonpecuniary loss tax penalty claims [not entitled to priority : 11 U.S.C. § 507(a)(7)(G)]:	$ 450,000
Pecuniary loss general unsecured claims:	$ 800,000
Total unsecured claims	$1,250,000

5. Class of unsecured claims is impaired and does not accept the plan.

Distribution analysis under Chapter 11 plan if all unsecured claims are in the same class:

The percentage to be distributed to unsecured creditors is determined by dividing the tota! amount of funds available for distribution by the total amount of unsecured claims.

$1,000,000/$1,250,000 = 80%

Appendix C

Amounts to be distributed:

Nonpecuniary loss tax penalty claims: 80% x $450,000 = $360,000	
Pecuniary loss general unsecured claims: 80% x $800,000 = $640,000	
Total to be distributed	$1,000,000

Best interest of creditors analysis:

Pursuant to 11 U.S.C. § 1129(a)(7), if an impaired class of claims does not accept a plan, the plan cannot be confirmed unless that impaired class receives under the plan on account of such claim property of a value that is not less than the claimant would receive if the debtor were liquidated under chapter 7 of the Bankruptcy Code. Accordingly, the court in this example must determine how the $1,000,000 would be distributed pursuant to 11 U.S.C. § 726.

In this example, the administrative and priority claimants would be paid in full under the chapter 11 plan or in the chapter 7 case. The remaining $1,000,000 would then be paid pursuant to 11 U.S.C. § 726(a) as follows:

Available for distribution	$1,000,000
Amount paid to general unsecured pecuniary loss creditors pursuant to 11 U.S.C. § 726(a)(2)	$ 800,000
Amount to be paid to unsecured nonpecuniary loss tax penalty claimants pursuant to 11 U.S.C. § 726(a)(4) ($1,000,000 - $800,000)	$ 200,000

Appendix C

Since general unsecured pecuniary loss creditors would receive more ($800,000) in a chapter 7 case than would be distributed to them under the plan ($640,000), the plan would not be confirmed unless those creditors voted to accept the plan.

PROBLEM: How to meet the best interest of creditors test to obtain confirmation of the debtor's chapter 11 plan and save 500 jobs.

SOLUTION: Include in the chapter 11 plan a provision to subordinate the unsecured nonpecuniary loss tax penalty claims so that the general unsecured creditors would receive the same amount under the plan as would be paid to them if the funds were distributed in a chapter 7 case. No misconduct is required in order to subordinate the unsecured nonpecuniary loss tax penalty claims.

Supreme Court, U.S.
FILED
MAR 13 1996
CLERK

No. 95-323

In the Supreme Court of the United States

OCTOBER TERM, 1995

UNITED STATES OF AMERICA, PETITIONER

v.

THOMAS R. NOLAND, TRUSTEE FOR DEBTOR
FIRST TRUCK LINES, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

DREW S. DAYS, III
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 514-2217

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The court of appeals recognized that Congress—writing with precision and detail—expressly provided postpetition tax penalty claims of the type involved in this case with a statutory "[f]irst" priority in the distribution of the assets of the debtor's estate (Pet. App. 3a). See 11 U.S.C. 503(b)(1)(C), 507(a)(1). The court stated, however, that it did "not see the fairness or the justice" of that legislative determination (Pet. App. 19a):

> We do not see the fairness or justice in permitting the * * * claim for tax penalties * * * to enjoy an equal or higher priority with claims based on the extension of value to the debtor * * *.

Believing that "fairness" and "justice" support the view (which Congress evidently did not share) that "claims based on extension of value to the debtor" should be paid before postpetition tax penalty claims, the court annulled and reversed the statutory priorities that Congress provided. The court did so quite emphatically and directly, by changing the priority for the tax penalty claims in this case from "[f]irst" to "last."

For the reasons detailed in our opening brief, the "principles of equitable subordination" that are codified in Section 510(c)(1) of the Bankruptcy Code (11 U.S.C. 510(c)(1)) do not support this judicial reinvention of the priority provisions of the Code. By allowing the court's own view of what is "fair" or "unfair" to override the express congressional determination of the priority to be afforded to these competing claims, the court of appeals violated the fundamental principle that a bankruptcy court's equitable powers "must and can only be exercised within the confines of the Bankruptcy Code" (*Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 206 (1988)). Principles of equitable subordination do not permit a court "to contradict statutory or common law when [it] feels a fairer result may be obtained by application of a different rule." *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d 784, 787 (9th Cir), cert. denied, 423 U.S. 913 (1975). They do not permit a court to say, "in effect * * * , 'No, the distribution scheme provided by [Congress] is a mistake.'" 516 F.2d at 788.

As this Court summarized in *Comstock* v. *Group of Institutional Investors*, 335 U.S. 211 (1948), the doctrine of equitable subordination has the quite different and narrower function of punishing creditors who engage in inequitable misconduct, by

"depriv[ing] the wrongdoer of the fruits of his wrong." *Id.* at 229. See also Pet. Br. 10-16. It is undisputed that the United States did not engage in any inequitable conduct in this case. The doctrine of equitable subordination therefore simply does not apply.

Respondent advances several arguments in support of the decision below. None of respondent's contentions substantiates the untenable proposition that, by codifying the preexisting "principles of equitable subordination," Congress authorized the courts to annul and disregard the hierarchy of detailed statutory priorities that Congress enacted to govern the rights of innocent claimants in bankruptcy cases. All but two of respondent's contentions are addressed in our opening brief. We reply here to the two contentions not previously addressed.

1. Respondent claims that there is a "bankruptcy policy of favoring pecuniary loss claims over nonpecuniary loss claims" and that "nonpecuniary loss tax penalties * * * have traditionally been disfavored" in bankruptcy (Resp. Br. 9, 20-21). These assertions are neither relevant nor factually correct.

Even if one could identify a source (other than the provisions of the Code) to determine what is "bankruptcy policy" and what is not, such "policy" has no lawful force if it has not been enacted as positive law. A court's perception of "policy" (as well as its perception of "fairness" and "justice") can not justify countermanding the statutory priorities that Congress has enacted. *E.g.*, *United States* v. *Killoren*, 119 F.2d 364, 366 (8th Cir.) ("[t]he plain mandate of the law cannot be set aside because of considerations which may appeal to referee or judge as falling within general principles of equity jurisprudence"), cert.

denied, 314 U.S. 640 (1941); *In re Columbia Ribbon Co.*, 117 F.2d 999, 1002 (3d Cir. 1941) (a "court may not by granting a priority which it deems equitable set aside the clear congressional mandate that no such priority shall be accorded").

Moreover, respondent's broad contention that "bankruptcy policy" disfavors nonpecuniary loss penalties is demonstrably incorrect. One need look no further than to Sections 503(b)(1) and 507(a)(1) of the Bankruptcy Code, which provide "[f]irst" priority for postpetition tax penalty claims, to see that "bankruptcy policy" is far more complex and articulated than respondent contends.[1] As this Court has explained, by providing a statutory priority for postpetition tax penalties, Congress sought to advance the legislative policy of ensuring compliance with the

[1] The only category of tax penalties that is "disfavored" in bankruptcy is *pre*petition nonpecuniary loss penalties in Chapter 7 cases. See 11 U.S.C. 726(a)(4) (subordinating such prepetition penalties to general unsecured claims). By contrast, as the court of appeals acknowledged, in providing a "[f]irst" priority for postpetition tax penalty claims, Congress did "not distinguish between tax penalties that are compensatory in nature and those that are not" (Pet. App. 15a). As we discuss in our opening brief (Pet. Br. 19 n.6), Congress has made detailed distinctions in the priorities provided to tax penalty claims in various differing contexts under the Bankruptcy Code. See Pet. App. 14a-15a ("In Chapter 7 cases, Congress assigned differing priorities to pre- and postpetition penalties. 11 U.S.C. §§ 726(a)(1) and 726(a)(4). * * * Section 726(a)(1) gives administrative expense priority to *postpetition* tax penalty claims."). The careful distinctions that Congress made in providing differing bankruptcy priorities for different types of tax penalty claims would be rendered meaningless if courts were permitted to apply "principles of equitable subordination" to disregard and annul the statutory priorities. See Pet. Br. 20-21.

tax laws by debtors in bankrupcy and thereby ensuring that such debtors abide by the same rules of law that apply to every other business (including those with whom they compete). *Nicholas* v. *United States*, 384 U.S. 678, 694 (1966); *Boteler* v. *Ingels*, 308 U.S. 57, 61 (1939).[2]

Although the court of appeals evidently disagreed with the policy judgment that Congress thus made in providing a "[f]irst" priority for postpetition tax penalty claims, the court was nonetheless bound by that legislative determination. As this Court emphasized

[2] Respondent errs in seeking to rely on *Simonson* v. *Grandquist*, 369 U.S. 38 (1962), as support for the proposition that penalty claims are disfavored in bankruptcy (Resp. Br. 21). Prior to 1978, *pre*petition penalty claims had been disallowed by statute under Section 57(j) of the Bankruptcy Act, 11 U.S.C. 93(j) (1976). *See Simonson* v. *Granquist*, 369 U.S. at 40. Although the Court stated in *Simonson* "that the language of §57(j) broadly prohibits the allowance of penalty claims in bankruptcy" (369 U.S. at 39), that statement was necessarily limited to the *pre*petition tax penalties involved in that case. In *Boteler* v. *Ingels*, which was decided two decades before *Simonson*, a unanimous Court had held that Section 57(j) did *not* bar a claim for *post*petition penalties incurred by the trustee. 308 U.S. at 61. And, four years after *Simonson*, the Court reaffirmed that holding in *Nicholas* v. *United States*, in concluding that the government's claim for a *post*petition tax penalty was allowable and entitled to first priority in distribution. 384 U.S. at 694 ("the United States is entitled to exact the penalties here in question as a legitimate means to enforce the prompt filing of the tax returns"). As noted in our opening brief (Pet. Br. 21 n.8), the majority and concurring opinions in the court of appeals overlooked *Nicholas* and *Boteler* and thereby erred in stating, without qualification, that "prior to 1978, nonpecuniary loss tax penalty claims against the estate of the bankrupt were not allowed by law" (Pet. App. 12a; see *id.* at 22a).

in *United States* v. *Sotelo*, 436 U.S. 268, 279 (1978), "[h]owever persuasive [alternative policy] considerations might be in a legislative forum, we as judges cannot override the specific policy judgments made by Congress in enacting the statutory provisions with which we are here concerned." See also Pet. Br. 14-16 & n.2.

2. Respondent contends that, even though Congress conferred a "[f]irst" priority on postpetition tax penalty claims as a matter of law, such claims should be subordinated as a matter of "equity" (even "without a finding of inequitable conduct" (Resp. Br. 24)) in order to avoid a perceived inconsistency with other provisions of the Bankruptcy Code.[3] Respondent grounds this contention on the theory that the statutory priority for postpetition tax penalty claims is "misguided" and should not be enforced (*id.* at 25).

But that assertion is nothing more than a contention that courts should disregard the priorities

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[3] Respondent suggests that equitable subordination of tax penalty claims is "not automatic" under the analysis of the court of appeals but is instead to "be determined on a case by case basis" (Resp. Br. 14). That description of the decision below is not correct. The court of appeals held that tax penalty claims are to be subordinated solely because it would be more "fair" for creditors "with claims based on the extension of value to the debtor" to be paid first (Pet. App. 19a). That rationale, if valid, would apply in every bankruptcy case involving an estate without sufficient assets to pay the claims of all creditors. In the rare case in which the estate has sufficient assets to satisfy all claims, there would be no need to invoke the doctrine of equitable subordination—for all claims would then be paid. Moreover, even on "a case by case basis", courts are not permitted to disregard statutory priorities soley on the theory that a *different* priority scheme might be more "fair" in a particular case. See Pet. Br. 9-16.

enacted by Congress if they conclude that "the distribution scheme provided by the [Bankruptcy Code] is a mistake" (*Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 788). It is unquestionably not the function of a court of equity, however, to "contradict statutory or common law" merely because the chancellor "feels a fairer result may be obtained by application of a different rule." *Id.* at 787. See Pet. Br. 11-17.

Moreover, there is nothing "misguided" about the detailed and complex set of priorities that Congress established in the Bankruptcy Code. Respondent complains that a "[f]irst" priority for tax penalty claims would require "any party doing business or extending credit postpetition to a trustee or debtor in possession" to demand "superpriority status before providing goods or services" (Resp. Br. 24). The "superpriority" provisions of the Bankruptcy Code permit a party who extends credit to the debtor after the petition is filed to obtain a priority "over any or all administrative expenses" but only if, *inter alia*, the trustee is otherwise unable "to obtain unsecured credit" (11 U.S.C. 364(c)(1)). Respondent suggests that the "delays" inherent in obtaining authorization for "superpriority" status from the bankruptcy court "could be fatal" to a debtor, and would therefore be "contrary to the strong bankruptcy policy in favor of rehabilitating or reorganizing debtors" (Resp. Br. 24). Respondent thus seems to contend that the priority that Congress established for postpetition tax penalty claims will frustrate the entire object of the Bankruptcy Code.

It could as easily be contended that, if Congress had determined *not* to provide a first priority for postpetition taxes and tax penalties, that determination

would have frustrated the entire object of the Internal Revenue Code.[4] The balancing of competing policy objectives is an inherently legislative function. Congress has performed that policy function by enacting the complex and detailed scheme of priorities set forth in the Bankruptcy Code. It is not the proper task of the bankruptcy courts to nullify the choices that Congress made based upon the court's differing perception of "fairness" and "justice" (Pet. App. 19a).[5]

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[4] In enacting the priority scheme of the Bankruptcy Code, Congress obviously gave a high priority to ensuring tax law compliance. It seems hardly necessary to point out that the dilemma that respondent poses—the threatened frustration and collapse of the entire bankruptcy scheme of reorganization—is most unrealistic. Respondent's stated concerns are obviously entirely irrelevant to a debtor that complies with its lawful duties under the Internal Revenue Code and thereby avoids the accrual of priority postpetition tax penalties. Moreover, the conditions precedent to the allowance of "superpriority" status have nothing to do with the risk of tax penalties—they are related to whether the credit status of the debtor is such that unsecured credit is not available. See 11 U.S.C. 364(c).

[5] Respondent's extended discussion (Resp. Br. 21-22 n.14) concerning the priority to be afforded to prepetition penalty claims in a case under Chapter 11 is irrelevant to this case, which involves the priority to be afforded to a postpetition first priority claim in a case under Chapter 7.

For the foregoing reasons and those set forth in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

DREW S. DAYS, III
Solicitor General

MARCH 1996